


1996

Municipal Securities Market: Same Problems -- No Solutions

Ann Judith Gellis

Indiana University Maurer School of Law

Follow this and additional works at: <http://www.repository.law.indiana.edu/facpub>

 Part of the [Commercial Law Commons](#), [Finance and Financial Management Commons](#), and the [Securities Law Commons](#)

Recommended Citation

Gellis, Ann Judith, "Municipal Securities Market: Same Problems -- No Solutions" (1996). *Articles by Maurer Faculty*. Paper 1030.
<http://www.repository.law.indiana.edu/facpub/1030>

This Article is brought to you for free and open access by the Faculty Scholarship at Digital Repository @ Maurer Law. It has been accepted for inclusion in Articles by Maurer Faculty by an authorized administrator of Digital Repository @ Maurer Law. For more information, please contact wattn@indiana.edu.

MUNICIPAL SECURITIES MARKET: SAME PROBLEMS — NO SOLUTIONS

BY ANN JUDITH GELLIS*

TABLE OF CONTENTS

	<i>Page</i>
INTRODUCTION	428
PART ONE — REGULATORY SKETCH THROUGH TIME	430
A. <i>Reactions to New York City Fiscal Crisis</i>	430
B. <i>1975 — 1989 Period</i>	433
1. Municipal Securities Rulemaking Board	433
2. Voluntary Disclosure	436
C. <i>WPPSS Default; Adoption of Rule 15c2-12</i>	436
D. <i>Period from 1990 — 1995</i>	440
1. Periodic Disclosure	441
2. MSRB Rule G-37	447
3. Other Regulation	452
PART TWO — HOW THE SYSTEM WORKS	452
A. <i>Studies/Cases</i>	452
B. <i>Orange County</i>	454
1. Background	455
2. Misery Loves Company	457
3. Review of Disclosure Documents	461
PART THREE — ANALYSIS	465
A. <i>Disclosure Incentives</i>	465
1. Disclosure by Issuers	467
2. Disclosure by Financial Professionals	469
B. <i>Too Many Cooks</i>	471
C. <i>Enforcement; Effectiveness</i>	473
D. <i>Consequences of Rule G-37</i>	476
CONCLUSION	481
APPENDIX A	483

*Professor of Law, Indiana University-Bloomington. I wish to thank J. William Hicks and Merritt B. Fox for their thoughts and time.

INTRODUCTION

Twenty years ago, the municipal securities market¹ was unregulated and virtually unknown. Although the dollar volume of municipal bonds issued each year was more than substantial, the workings of the market attracted little attention other than from underwriters and legal counsel who specialized in municipal bond finance. A standard municipal bond issue was a public offering of general obligation bonds, sold by a syndicate of underwriters who had been chosen by competitive bidding. Disclosure was not required and nonexistent. Those who purchased municipal securities were well defined and included commercial banks, property and fire casualty insurance companies, and wealthy individuals. These groups were able to take advantage of the federal income tax exemption of interest paid on municipal bonds.

Then came the near default of New York in 1975 on \$600 million of debt, followed by the default of the Washington Public Power Supply System (WPPSS) on \$2.5 billion of outstanding bonds in 1988.² Furthermore, for the first six months of 1995, the market was anticipating the default of bankrupt Orange County, California on \$800 million of short-term debt due in the summer of 1995. Orange County managed to renegotiate a one-year extension of the debt and avoided payment default.³ In recent months, stories of widespread corruption in the municipal securities market have made headlines in major newspapers, prompting a number of investigations and criminal indictments. The front page of *The Bond Buyer*, a daily trade newspaper, often reads like a local crime beat column.⁴

¹The term "municipal securities" refers to the debt obligations of states and their political subdivisions (e.g., municipalities, counties, towns, special districts, and school districts).

²See generally SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE COMMISSION ON BANKING, FINANCE AND URBAN AFFAIRS, 95th Cong., 1st Sess., STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK (Comm. Print 1977) [hereinafter NEW YORK SEC REPORT] and DIVISION OF ENFORCEMENT, SECURITIES AND EXCHANGE COMMISSION, STAFF REPORT ON THE INVESTIGATION IN THE MATTER OF TRANSACTIONS IN WASHINGTON PUBLIC POWER SUPPLY SYSTEM SECURITIES (Sept. 1988) [hereinafter WPPSS SEC REPORT] for discussions of the events and circumstances of these two fiscal crises.

³See *infra* note 179 and accompanying text.

⁴See, e.g., Joyce Hanson, *New Jersey Executives Face SEC, Justice Charges on Kickback Ploy*, THE BOND BUYER, Feb. 24, 1995, at 1; Diana B. Henriques, *U.S. Steps Up Municipal Bond Investigations*, N.Y. TIMES, Jan. 25, 1995, at D1; Lynn Stevens Hume, *SEC Official Says Bond Enforcement Major Priority for Municipal Market*, THE BOND BUYER, Jan. 26, 1995, at 1; Leslie Wayne, *There's a New Sheriff in Town*, N.Y. TIMES, Nov. 10, 1995, at D1; Donald Yacoe, *Escambia County, Florida, Defendants Plead Guilty in Pay to Play Case*, THE BOND BUYER, Mar. 6, 1995, at 6.

Today the municipal securities industry barely resembles the pre-New York City crisis market. The types of securities issued and the nature of investors and other participants have changed and expanded in number. Municipal securities mutual funds and municipal bond insurance, each a major factor in today's market, were virtually nonexistent before 1974. Finally, the regulatory environment has changed significantly, so much so, that the current Chairman of the Securities and Exchange Commission (SEC), Arthur Levitt, has made the oversight of the municipal securities market the primary focus of his tenure at the SEC.⁵

Since Chairman Levitt's appointment, the SEC has, both directly and indirectly, advocated for major regulation of the municipal securities market. It has also focused its enforcement energies on cleaning up the market.⁶ It has conducted a record number of investigations against municipal securities dealers.⁷ Within days of the news of Orange County's debacle in December 1994, the SEC began an investigation to see if there were any violations of the antifraud provisions of the federal securities laws. In March 1995, the SEC created, for the first time, a division specifically devoted to issues of municipal finance, the Office of Municipal Finance.

While much of Congress is moving to deregulate and "devolve" power to the states, the SEC is moving in the opposite direction, involving itself in matters which arguably are more properly the domain of state and local governments. In the areas of corruption of governmental officials and campaign reform, states appear willing to let the federal government lead, perhaps in recognition that it is not realistically possible for the states to regulate themselves.

This article examines the existing regulations of the municipal securities market, focusing on what activities prompted the regulatory

⁵Wayne, *supra* note 4, at D1. Levitt declared, "Municipal finance is the No. 1 priority of the commission." *Id.* at D1.

⁶There have been reports of SEC investigations in connection with securities transactions involving Denver, the District of Columbia, and Maricopa County, Arizona, among others. Brad Altman, *SEC Wants to See if County in Arizona Glossed Over Woes Before Three Issues*, THE BOND BUYER, Feb. 14, 1995, at 20; Lynn Stevens Hume, *District of Columbia Disclosure Issues Recall WPPSS, Taylor Says*, THE BOND BUYER, Feb. 10, 1995, at 5; see also Wayne, *supra* note 4, at D1 (discussing a \$24 million SEC settlement with Merrill Lynch and Lazard Freres and a \$1.4 million settlement with Stifel Nicolaus, a regional broker).

⁷The term "municipal securities dealers" is used in this article to refer to brokers and dealers of municipal securities, whether exclusively or as a part of a securities business, and banks who underwrite and trade in municipal securities. Banks are authorized under the Glass-Steagall Act to buy and sell general obligation bonds and certain types of revenue bonds. 12 U.S.C. § 24, para. Seventh (1994).

changes and analyzing the direction and efficacy of these regulations in terms of the deficiencies in the market. Part One gives a background sketch of the market and its participants from the time of the New York City fiscal crisis to today. Part Two discusses whether the existing regulation is sufficient to produce disclosure, focusing on the Orange County crisis. Part Three offers a critique of the current regulatory scheme and makes some suggestions for reform.

Clearly, the enactment of regulations governing underwriting and trading practices in the municipal securities market has had very positive effects in bringing about more disclosure of information and more uniformity in the standards for disclosure. However, disclosure remains legally voluntary on the part of issuers. The existing SEC scheme of regulation rests shakily on the SEC's authority to regulate under the antifraud provisions of the Securities Exchange Act of 1934 (the 1934 Act)⁸ rather than on a separate legislative structure, as in the case of the corporate securities market.

The market continues to suffer from the lack of timely disclosure of information. Observers of the market note that, despite the changes in the legal climate with respect to disclosure, the rating agencies still constitute the dominant force in the decision-making process for both the investor and issuer.

At a more technical level, with the increased role of the SEC, one must question the need for the Municipal Securities Rulemaking Board, as presently structured. As it is, the decision in 1975 to preserve the balance of power between the federal, state and local governments, by not regulating disclosure by municipal issuers, directly resulted in a more cumbersome regulatory structure. Similarly, the reactions to other deficiencies, such as corruption in the selection of underwriters and poorly run municipal investment policies, tend to be solutions which add more layers of participants, arguably increasing the possible points of corruption in any particular securities offering.

PART ONE — REGULATORY SKETCH THROUGH TIME

A. *Reactions to New York City Fiscal Crisis*

The New York City fiscal crisis was a wake-up call to both the securities market and Congress that the staid municipal securities market had changed. The old rule of no rules had to be reexamined. For the

⁸15 U.S.C. § 78 (1994).

first time, questions were raised about the serious inadequacies in market information, particularly in light of the growth in the types of municipal issuers, the types of securities being sold, and the number and types of investors.⁹ New York City's close call with default raised the basic question of how an issuer, the magnitude of New York City, could get to the brink of bankruptcy without the market's knowledge?

In reaction, Congress took its first tentative step to regulate the municipal securities market. It rejected legislative efforts to simply eliminate the section 3(a) exemption for municipal issuers from the

⁹In the past twenty years, the municipal securities market has seen an expansion of the market accompanied by a shift from general obligation bonds to revenue bonds, the development of the bond insurance industry for less credit-worthy municipal bonds and perhaps most significantly, the wider ownership of municipal bonds by individual investors in the middle income brackets. Total municipal obligation debt outstanding in 1994 was \$1,209.9 trillion, as compared with \$341.5 billion in 1979. Individual investors held \$409 billion of municipal debt in 1994; in 1979, they held \$74.3 billion. In 1994, mutual funds held \$220.6 billion of municipal securities; in 1974, the amount was \$1 billion; \$61.3 billion of bonds were insured in 1994, as compared to \$63 million in 1974. See generally Ann Judith Gellis, *Mandatory Disclosure for Municipal Securities: A Reevaluation*, 36 BUFF. L. REV. 15, 25-40 (1987) (discussing shifts in the municipal securities market which had already occurred in the 1980s). These trends have continued, particularly in terms of the types of securities issued. See also SECURITIES AND EXCHANGE COMMISSION, DIVISION OF MARKET REGULATION, SEC STAFF REPORT ON THE MUNICIPAL SECURITIES MARKET 1-5 (Sept. 1993) [hereinafter 1993 SEC STAFF REPORT] (stating that the municipal securities market comprises approximately 50,000 state and local issuers with an outstanding principal amount in excess of \$1.2 trillion). The 1993 SEC Staff Report provides:

The types of securities municipalities generally issue include general obligation bonds, revenue bonds, and conduit bonds. General obligation bonds are secured by the full faith and credit and general taxing power of the issuer. A holder of general obligation bond may look for repayment to all sources of revenue that the municipality is entitled to receive. Revenue bonds, on the other hand, are typically issued to support a particular project, and are paid for out of revenues from that project. "Conduit" bonds, such as industrial development bonds, are securities issued to finance a project that is to be used in the trade or business of a private corporation. Typically, investors must look solely to the credit of the private entity for payment of interest and principal.

During the past few years, the municipal bond market has experienced a proliferation of complex derivative products. Among these are principal and interest strips, pooled municipal investment vehicles, detachable call options, and new variable rate securities. These new forms of municipal securities are designed to reduce issuers' costs while creating securities that meet perceived investment needs of particular types of municipal investors. The complexity of new products appears to be limited only by the ingenuity of investment bankers and inherent limitations on issuers as a result of state and federal laws, including federal tax laws.

Id. at 1.

registration provisions of the Securities Act of 1933 (1933 Act),¹⁰ which would have resulted in municipal and corporate securities issuers being treated the same in terms of public primary offerings of securities. As a compromise, Congress created a regulatory body, the Municipal Securities Rulemaking Board (MSRB or Board),¹¹ to establish fair practices for underwriting and trading of municipal securities. Congress also required brokers and dealers of municipal securities to register with the SEC.¹² But, through the Securities Acts Amendments of 1975, Congress specifically prohibited the imposition of any pre-issuance filing requirements, by either the SEC or the newly-created MSRB, on municipal issuers in connection with the issuance, sale, or distribution of securities.¹³ Congress also prevented the MSRB from getting around this prohibition by forbidding any requirement that brokers and dealers furnish documents related to an issuer unless such information is generally available from other sources.¹⁴ These amendments to section 15B of the 1934 Act are known collectively as the Tower Amendment.

¹⁰15 U.S.C. § 77a (1994). At the time of the New York City crisis, two bills were introduced in Congress, each of which would have required mandatory disclosure. S.2574, 94th Cong., 1st Sess., 121 CONG. REC. 33,907 (1975); S.2969, 94th Cong., 2d Sess., 122 CONG. REC. 3321 (1976); see Ann Judith Gellis, *Mandatory Disclosure for Municipal Securities: Issues in Implementation*, 13 J. CORP. L. 65, 75-77 (1987) for a discussion of these bills.

¹¹15 U.S.C. § 78o-4(b)(1) (1994).

¹²*Id.* § 78o-4(a)(1)-(2).

¹³Section 78o-4(d)(1) provides:

Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.

15 U.S.C. § 78o-4(d)(1) (1994).

¹⁴Section 78o-4(d)(2) provides:

(2) The Board is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer: *Provided, however*, That the Board may require municipal securities brokers and municipal securities dealers to furnish to the Board or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this chapter.

15 U.S.C. § 78o-4(d)(2) (1994).

The Tower Amendment forms the structural foundation of the current municipal securities regulatory scheme in that directives as to market practices and procedures, including any requirements for disclosure, are imposed on municipal securities dealers alone. As a result, regulations as to information disclosure are primarily procedural. The SEC has shied away from any content regulation because of the prohibitions of the Tower Amendment. Any affirmative obligation on the part of municipal issuers to provide information to investors is imposed indirectly through application of the antifraud provisions of the securities laws to municipal issuers, and interpretation of those provisions by the SEC as they relate to the offering of municipal securities to the public.¹⁵

The inability to regulate the market behavior of municipal issuers, except indirectly, has resulted in a skewed regulatory scheme where the interests of issuers are underrepresented, and the public's interest in getting accurate and timely information is still dependent on voluntary compliance by the issuers. It is perhaps too early to know, but the startling bankruptcy of Orange County may suggest that this reliance is ill-founded.

B. 1975 — 1989 Period

1. Municipal Securities Rulemaking Board

There were two significant changes in the Securities Acts Amendments of 1975 concerning municipal securities. Section 3(a)(9) of the 1934 Act¹⁶ was added to clarify that municipal issuers could be sued under section 10(b), and section 15B was added to create the MSRB.¹⁷

The MSRB is a hybrid organization, a combination of a government regulatory body — a mini-SEC for municipal securities — and a self-regulatory body, comparable to the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) for

¹⁵Municipal Securities Disclosure, Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799 (July 10, 1989); Municipal Securities Disclosure, Exchange Act Release No. 33,742, 59 Fed. Reg. 12,759 (Mar. 17, 1994); Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,950 (Nov. 10, 1994). These releases, accompanying the adoption of Rule 15c2-12 and the proposed amendments of Rule 15c2-12 in 1994, set forth the SEC's views with respect to the disclosure obligations of participants in the municipal securities market under the antifraud provisions of the federal securities laws. In general, the SEC relies on the authority under § 10(b) and § 15(c)(1) and (2) of the 1934 Act. 15 U.S.C. §§ 78(b), 78(c)(1)-(2) (1994).

¹⁶15 U.S.C. § 78e (1994).

¹⁷15 U.S.C. § 78o-4(b)(1) (1994).

corporate securities. The Board, located in Washington, D.C., is by statute dominated by dealers and banks, who, as the underwriters and traders of municipal securities offerings, are the subjects of the Board's regulations. The Board has five members from investment banking firms, five members from commercial banks, and five representatives of the public which includes a minimum of one representative of issuers and one representative of investors.¹⁸

Much of the regulatory efforts of the MSRB has focused on standardizing municipal securities trading practices. For example, Rule G-8 (books and records); Rule G-15 (confirmation, clearance, and settlement); G-17 (conduct of municipal securities business); and G-30 (prices and commissions),¹⁹ to name a few. In this respect, given the type of regulation and the makeup of the Board, the MSRB resembles the other self-regulatory organizations (SROs). But, its powers are defined by statute and its rules have the force of law. All rules, however, require the approval of the SEC, as is true of the other SROs.²⁰ Enforcement of the MSRB rules is left to the SEC, the NASD, and with respect to bank municipal securities dealers, the bank regulatory agencies: Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation.²¹

A number of the rules of the MSRB are aimed at promoting disclosure and better distribution of information to the market. For example, Rule G-32 requires dealers to provide to their customers copies

¹⁸*Id.*

¹⁹MUNICIPAL SECURITIES RULEMAKING BOARD MANUAL (CCH) ¶¶ 3536 (Rule G-8), 3571 (Rule G-15), 3581 (Rule G-17), 3646 (Rule G-30) (1995) [hereinafter MSRB MANUAL].

²⁰In the Senate Committee Report for the Securities Acts Amendments of 1975, it is clear that the SEC has oversight responsibility in the same way it has oversight responsibilities for the other self-regulatory organizations under § 19(c) of the 1934 Act. In 1975, the U.S. Senate commented:

Regular and systematic Commission review of proposed self-regulatory rules alone is not sufficient to enable the Commission to discharge its ultimate responsibility to ensure that Board rules are in conformity with the public interest and applicable statutory standards. In addition, the Commission must be in a position to review existing Board rules and policies to consider their adequacy in light of new knowledge and experience and changed regulatory circumstances. By continuously examining market circumstances and regulatory needs, appraising and reappraising the adequacy of existing regulatory measures, the Commission can exercise its supervisory powers to ensure the continuing validity of self-regulation and the effectuation of the purposes of the bill.

S. COMM. REP. NO. 75, 94th Cong., 1st Sess. 50 (1975).

²¹15 U.S.C. § 78o-4(c)(2), (5) (1994).

of official statements, voluntarily supplied by an issuer.²² Rule G-36 requires that copies of final official statements be filed with the MSRB.²³ Rule G-19, the "suitability rule," requires dealers to have "reasonable grounds" for believing that the recommendation of a sale to a customer is suitable for that customer, and such belief is to be founded on reasonable investigation.²⁴

Most recently, with the adoption of Rule G-37,²⁵ the MSRB has also focused its attention on "leveling the playing field." Through regulation of "pay-to-play" practices, the MSRB is seeking to root out corruption and "questionable activities" in the municipal securities market.²⁶

The above descriptions are certainly not exhaustive of the MSRB's activities and influence. The purpose here is to emphasize that for the fourteen year period, from 1975 until the adoption of Rule 15c2-12 by the SEC in 1989, the MSRB was the primary, and, in terms of disclosure and distribution of information, the only regulator of the municipal securities market.²⁷ Furthermore, during this period, municipal securities market participants came to recognize that the days of nondisclosure were over. Investors would require better information from issuers — Tower Amendment or no Tower Amendment.

²²MSRB MANUAL, *supra* note 19, ¶ 3656 (Rule G-32).

²³*Id.* ¶ 3676 (Rule G-36).

²⁴*Id.* ¶ 3591 (Rule G-19). In the last year, this rule has taken on added importance because of the losses experienced by local governments on their investments in derivatives securities.

²⁵*Id.* ¶ 3681 (Rule G-37).

²⁶See *infra* part I.D.2 for a discussion of MSRB activity with respect to eliminating "pay-to-play" practices in the municipal securities market.

²⁷Traditionally, there has been little regulation of the municipal securities market at the state level. Generally, the issuance of securities by a local government is subject to a state securities antifraud provision which resembles Exchange Act Rule 10b-5. In a case arising out of the WPPSS default, the Washington State Supreme Court held that the test under the Washington statute was one of negligence, not scienter. In response, the legislature changed the test to scienter, except regarding bond counsel and underwriters. See 2 M. DAVID GELFAND, STATE AND LOCAL GOVERNMENT DEBT FINANCING §§ 8:50, 8:51 (1995).

Distinct from state securities regulation is state regulation of the financial health of the state's political subdivisions. The extent of regulation is different in each state. By the 1970s, a number of states required the filing of annual reports, but nothing more. A very few required state approval of bond offerings. Today, states are more active in monitoring the financial well-being of their local governments. See *supra* notes 8-15 and accompanying text.

2. Voluntary Disclosure

In 1979, Congress considered the deficiencies of the municipal securities market evident in the mid-seventies. The Government Finance Officers Association (GFOA) issued "Disclosure Guidelines for State and Local Government Securities."²⁸ Revised in 1988, and again in 1991, these guidelines have been the mainstay of municipal securities disclosure standards. Other groups have since issued recommended disclosures for their constituents, but the GFOA Guidelines remain the foremost set of voluntary disclosure standards.²⁹ The organization itself is the primary voice for municipal securities issuers in the regulation and operation of the market and, as such, is an important player in determining regulation of the market.

There are two sets of guidelines, one for preparation of official statements, the other for preparation of continuing disclosure, the latter issued in 1979 and subsequently revised in 1991. The guidelines for offerings are organized to provide an issuer with a structure for presenting information, beginning with the cover page of the official statement and a description of what kinds of information should be included in each section of the official statement.³⁰

C. WPPSS Default; Adoption of Rule 15c2-12

The WPPSS default in 1988, however, made it apparent that the MSRB rules and market forces alone were not sufficient to correct the informational problems of the municipal bond market. There had been

²⁸GOVERNMENT FINANCE OFFICERS ASSOCIATION, DISCLOSURE GUIDELINES FOR STATE AND LOCAL GOVERNMENT SECURITIES (4th ed. 1991). See Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Release No. 33,741, 59 Fed. Reg. 12,748 (Mar. 17, 1994) (discussing the role of the guidelines and noting that the guidelines have widespread acceptance). The 1993 SEC Staff Report points out, however, that the guidelines, which serve as the industry standards, call for less disclosure than the SEC requires for registered corporate offerings. 1993 SEC STAFF REPORT, *supra* note 9, at 24.

²⁹For example, the National Federation of Municipal Analysts, *Disclosure Handbook for Municipal Securities — 1992 Update*; Healthcare Financial Management Association, *Principles and Practices Board Statement 18 — Public Disclosure of Financial and Operating Information by Healthcare Providers*. See 1993 SEC STAFF REPORT, *supra* note 9, at 55 (listing other industry guidelines, e.g., Public Securities Association Recommendations; Guidelines for State Auditors, Comptrollers and Treasurers; and Guidelines for Housing Agencies).

³⁰Information may include a description of the security, presentation of financial information and information needed in conduit offerings. .

major improvements in disclosure of information, including more uniformity, with much credit going to the efforts of the GFOA. However, the behavior of issuers, underwriters and counsel, as evidenced by the WPPSS official statements, continued to fall short in terms of adequate disclosure.³¹

In 1989, after an investigation of the WPPSS securities transactions, the SEC stepped in to directly regulate the primary offerings of municipal securities with the adoption of Rule 15c2-12.³² Rule 15c2-12 was issued pursuant to the authority given to the SEC under the antifraud provisions of sections 10 and 15 of the 1934 Act. As discussed above, the prohibitions contained in the Tower Amendment do not permit direct disclosure regulation of issuers, at least in terms of imposing any pre-filing requirement. Thus, Rule 15c2-12 indirectly regulates issuers by regulating the activities of underwriters of municipal securities.³³

Rule 15c2-12 basically requires underwriters (1) to obtain and review a "deemed final official statement of the issuer" prior to bidding for, offering, or selling municipal securities in a primary offering; and (2) to distribute copies of the official statement to potential purchasers, who so request, within ninety days of the end of the underwriting period.³⁴

³¹See Gellis, *supra* note 9, at 69-70.

³²17 C.F.R. § 240.15c2-12 (1995). Accompanying the proposed rule was a lengthy interpretive release on the investigative obligations of underwriters. Municipal Securities Disclosure, Exchange Act Release No. 26,100, 53 Fed. Reg. 37,778 (Sept. 28, 1988). The final rule was issued, with a few slight modifications from the proposed rule, in 1989. Municipal Securities Disclosure, Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799 (July 10, 1989). The thrust of the interpretive release was that underwriters must conduct a review of the issuer and the offering sufficient to allow the underwriter to represent that it has a "reasonable basis for belief in the accuracy and completeness of the key representations in the documents." *Id.* at 28,811.

³³See *supra* notes 11-14 and accompanying text.

³⁴The Rule specifies that an underwriter:

- (1) Prior to the time the Participating Underwriter bids for, purchases, offers, or sells municipal securities in an Offering, the Participating Underwriter shall obtain and review an official statement that an issuer of such securities deems final as of its date, except for the omission of no more than the following information: The offering price(s), interest rate(s), selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, other terms of the securities depending on such matters, and the identity of the underwriter(s).
- (2) Except in competitively bid offerings, from the time the Participating Underwriter has reached an understanding with an issuer of municipal securities that it will become a Participating Underwriter in an Offering until a final official statement is available, the Participating Underwriter shall send no later than the next business day, by first-class mail or other equally prompt

The Rule also introduces the concept of Nationally Recognized Municipal Securities Information Repositories (NRMSIRs), as a key to the distribution of information in the marketplace.³⁵ Unlike the scheme for corporate securities regulation, there are no requirements to file any documents with the SEC either for review or, simply, as an informational filing.³⁶ Rather, the Rule contemplates filing with private entities set up to provide the public with access to information about municipal issuers and their securities.³⁷ To encourage the use of NRMSIRs, the filing of a copy of the final official statement with a NRMSIR shortens the period in which an underwriter is obligated to distribute copies of the official statement to purchasers from ninety to twenty-five days from the end of

means, to any potential customer, on request, a single copy of the most recent preliminary official statement, if any.

(3) The Participating Underwriter shall contract with an issuer of municipal securities or its designated agent to receive, within seven business days after any final agreement to purchase, offer, or sell the municipal securities in an Offering and in sufficient time to accompany any confirmation that requests payment from any customer, copies of a final official statement in sufficient quantity to comply with paragraph (b)(4) of this rule and the rules of the Municipal Securities Rulemaking Board.

(4) From the time the final official statement becomes available until the earlier of (i) Ninety days from the end of the underwriting period or (ii) The time when the official statement is available to any person from a nationally recognized municipal securities information repository, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in an Offering shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the final official statement.

17 C.F.R. § 240.15c2(b)(1)-(4) (1995).

The term "deemed final" is defined to mean the completed document delivered to the underwriters by the issuer containing all material information about the issuer and the issue, except that price information, interest rates, underwriters compensation, etc., may be left out. See GELFAND, *supra* note 27, § 8:10 (discussing the rule and its application).

³⁵17 C.F.R. § 240.15c2-12(b)(4) (1995). The term NRMSIR is not defined in the Rule. See Municipal Securities Disclosure, Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799, 28,808 n.65 (July 10, 1989), which sets forth the factors the SEC would use to determine whether a repository would be recognized as a NRMSIR. See also Municipal Securities Disclosure, Exchange Act Release No. 33,742, 59 Fed. Reg. 12,759, 12,764-12,7665 (Mar. 17, 1994) (discussing the concept of NRMSIRs). In the adopting release for the amendments to Rule 15c2-12, the SEC decided that the factors originally set forth would not be altered and the SEC practice of reviewing proposals for NRMSIRs and issuing no action letters for firms meeting the standards would be left in place. Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,970-85,971 (Nov. 10, 1994).

³⁶Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,970-85,971 (Nov. 10, 1994).

³⁷*Id.*

the underwriting period.³⁸ The end of the underwriting period is defined as the later of such time as "(i) the issuer of municipal securities delivers the securities to the Participating Underwriters or (ii) the Participating Underwriter does not retain, directly or as a member of an underwriting syndicate, an unsold balance of the securities for sale to the public."³⁹

At the time of the Rule's adoption, there were no NRMSIRs in existence. The MSRB had proposed to set up a central filing system under its aegis. The SEC, however, rejected the Board's centralized filing proposal in favor of the competitive private sector system of NRMSIRs.⁴⁰

To be approved as a NRMSIR, the entity must demonstrate that it is national in scope, maintains current and accurate information, has an effective retrieval and dissemination system, is open to any issuer, and allows public access to the information at reasonable cost.⁴¹ It is the practice for entities seeking to be a NRMSIR to file their proposals with the SEC. If approved, the SEC issues a "no action" letter to the entity.⁴²

At present, there are six SEC-approved NRMSIRs for documents filed under Rule 15c2-12.⁴³ With the 1994 amendment, Rule 15c2-12, which requires the filing of periodic disclosure documents with NRMSIR,⁴⁴ the number of other companies planning to apply for recognition as NRMSIRs is expected to grow. And, in fact, three of the six NRMSIRs are post Rule 15c2-12 amendment additions.⁴⁵

Rule 15c2-12 does not apply to primary offerings of an aggregate principal amount of less than \$1 million.⁴⁶ Also, exemptions from the

³⁸17 C.F.R. § 240.15c2(b)(4) (1995).

³⁹17 C.F.R. § 240.15c2-12(f)(2)(i)-(ii) (1995).

⁴⁰The MSRB operates a central file, called the Municipal Securities Information Library (MSIL), in which primary and secondary market disclosure documents are filed. Pursuant to MSRB Rule G-36, two copies of official statements are required to be given to the MSRB, one of which is filed in the MSIL. The MSIL is not, however, a NRMSIR. There was considerable debate among market participants over the issue of a central versus many repositories. For discussions of this issue and, more broadly, the role of the MSRB as a repository, see Symposium, *The Future Role and Governance of the MSRB*, 12 MUN. FIN. J. 48 (1991).

⁴¹See Municipal Securities Disclosure, Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799, 28,808 n.65 (July 10, 1989).

⁴²See *supra* note 35.

⁴³The current list of NRMSIRs are: Kenny Information Services; Bloomberg Financial Markets; The Bond Buyer, Disclosure, Inc.; Moody's NRMSIR; and R.R. Donnelly Financial Municipal Resource Center, which is on the Internet.

⁴⁴See *infra* text accompanying notes 65-70 (discussing Rule 15c2-12(b)(5)).

⁴⁵Disclosure, Inc., Moody's NRMSIR, and R.R. Donnelly were approved subsequent to the amendment of Rule 15c2-12.

⁴⁶17 C.F.R. § 240.15c2-12(a) (1995).

Rule are given for offerings in denominations of \$100,000 or more if (1) the securities are sold to no more than thirty-five financially sophisticated persons with investment intent, (2) the securities are short term debt (nine months or less), or (3) the securities are "put" securities where the holders can demand payment at least as frequently as every nine months.⁴⁷

Accompanying the SEC's Rule 15c2-12 was an interpretive release, setting forth the Commission's views on the duty of underwriters to make investigations prior to commencing an offering.⁴⁸ The SEC acknowledged that the creation of the MSRB in 1975, and the increased use of the GFOA's disclosure guidelines following the New York City crisis, had not had the influence expected on underwriters' behavior with respect to their obligations to investigate statements contained in the official statement.⁴⁹ The SEC recognized that the reasonableness of an investigation necessary to avoid liability under the antifraud provisions depends on, among other things, whether the offering is competitively bid or negotiated.⁵⁰ However, the test is the same, the underwriter must have a reasonable basis for belief in the bulk of key representations in the official statements prepared by the issuer.⁵¹ The release specifically addressed the practical difficulties in performing due diligence investigations in competitively bid offerings.⁵²

Thus, by 1991, there was a system of federal regulation which essentially required new offerings to be accompanied by a final official statement of the issuer, and provided for the distribution of the official statements to the market either through the NRMSIRs or the MSRB. The content of the official statements, however, as it related to the issuer, remained unregulated.

D. Period from 1990 — 1995

The period following the enactment of Rule 15c2-12 continued to be a time of examination and activity, as the various participants changed their ways of issuing municipal securities in light of the dictates of the

⁴⁷17 C.F.R. § 240.15c2-12(d) (1995).

⁴⁸Municipal Securities Disclosure, Exchange Act Release No. 26,100, 53 Fed. Reg. 37,778, 37,787 (Sept. 28, 1988).

⁴⁹*Id.* at 37,788.

⁵⁰*Id.* at 37,789.

⁵¹Municipal Securities Disclosure, Exchange Act Release No. 26,100, 53 Fed. Reg. 37,778, 37,789 (Sept. 28, 1988).

⁵²*Id.* at 37,788-37,789 n.81. The use of competitive bidding is one of the major differences between the municipal and corporate securities markets.

Rule.⁵³ The major questions and issues of compliance revolved around what constituted a "deemed" final official statement and whether certain types of remarketings were covered as primary offerings. Structurally, the roles of financial advisors and underwriters' counsel gained in importance, and the need for separate issuer securities counsel, apart from bond counsel, became more apparent.

Having put the regulation of the primary market in place, the SEC and the MSRB turned their attention to disclosure for the secondary market and ridding the market of a climate of corruption.

1. Periodic Disclosure

The municipal securities secondary market for trading is characterized by mystery. There has been little information about the secondary market in terms of the volume and makeup of the participants in the market. The traditional view has been that most investors, including to some extent the banks and insurance companies, hold municipal securities until maturity.⁵⁴ To date, trading has not been significant. Small trades are expensive and discouraged. Those people who do trade tend to be sophisticated financial entities, trading in large blocks of securities. The average trading block is estimated to be \$25,000 for individuals and \$100,000 for institutions.⁵⁵ As a consequence, individuals, even wealthy ones, are not active traders.

In a report on the municipal securities market issued in September 1993, the SEC staff emphasized the need for greater price information to facilitate trading.⁵⁶ To this end, the Commission proposed a rule in March 1994 which would have required disclosure of mark-ups in riskless principal transactions in municipal securities.⁵⁷ Meanwhile, at the

⁵³It is not the intent of this article to detail and analyze the specific provisions of Rule 15c2-12 and its application over the last five years. Rather, the focus is more on the structure of municipal securities regulation and its overall effectiveness. For detailed analysis of Rule 15c2-12, particularly, the provisions relating to primary disclosure. See GELFAND, *supra* note 27, §§ 8:10-8:10.95.

⁵⁴See Gellis, *supra* note 10, at 106-08; see also 1993 SEC STAFF REPORT, *supra* note 9, at 28-31 (discussing the growth of a secondary market in municipal securities trading and the need for a system of disclosure to inform secondary purchasers).

⁵⁵These are estimates from traders. There is no more specific information available.

⁵⁶See 1993 SEC STAFF REPORT, *supra* note 9, at 11-17.

⁵⁷Confirmation of Transactions, Exchange Act Release No. 33,743, 59 Fed. Reg. 12,767 (Mar. 17, 1994).

The confirmation serves several functions: it acts as a customer invoice; informs investors of the details of a transaction, allowing the investor to check for errors or misunderstandings, provides consumer information,

SEC's urging, the MSRB began a pilot program to improve price transparency for trades between dealers, with the hope that the information reported by dealers would enable the MSRB to make price information for municipal securities transactions publicly available on a next day basis. Phase one of the program covered reported information on those issues that traded four or more times a day.⁵⁸ The MSRB estimated that somewhere between 80 and 350 issues may trade four or more times a day, with 180 issues as an average.⁵⁹ At the time, there were an estimated 1.5 million municipal issues outstanding.⁶⁰

Phase two of the program requires dealers to report daily to the MSRB all inter-dealer transactions.⁶¹ Citing the MSRB pilot program and other efforts to enhance price transparency by the Public Securities Association (PSA), the SEC in November 1994 postponed its mark-up proposal for six months.⁶² No action has yet been taken.

On February 28, 1995, the MSRB also amended a number of its rules to require trades to be settled within three business days of the trade date, known as T+3.⁶³ This rule parallels SEC's Rule 15c6-1 under the 1934 Act,⁶⁴ which mandates T+3 settlement with respect to the settlement of trades in the corporate securities market.

Finally, but certainly not least of all, in November 1994, the SEC amended Rule 15c2-12 to add the new paragraphs (b)(5) and (c),⁶⁵ requiring continuous disclosure by issuers of municipal securities. Like the regulation of disclosure in the primary market, the amended Rule regulates issuers indirectly. Dealers are prohibited from underwriting the securities of any issuer who does not agree in writing to provide to the

allowing investors to evaluate the cost and quality of the services provided by broker-dealers; discloses to investors possible conflicts of interest between them and the broker-dealer; and acts as a safeguard against fraud, by permitting the customer to detect problems associated with a transaction.

Id.

⁵⁸MSRB MANUAL, *supra* note 19, ¶ 10,610, at 11,221; *id.* ¶ 10,624, at 11,252.

⁵⁹*Id.* ¶ 10,610, at 11,221.

⁶⁰*Municipal Securities Market, Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 103d Cong., 1st Sess. (1993) [hereinafter *1993 Congressional Hearings*].

⁶¹MSRB MANUAL, *supra* note 19, ¶ 10,637, at 11,294.

⁶²Confirmation of Transactions, Exchange Act Release No. 34,962, 59 Fed. Reg. 59,612 (Nov. 17, 1994).

⁶³MSRB MANUAL, *supra* note 19, ¶ 10,650, at 11,328.

⁶⁴Securities Transactions Settlement, Exchange Act Release No. 33,023, 58 Fed. Reg. 52,891 (Oct. 13, 1993).

⁶⁵*Municipal Securities Disclosure*, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,950 (Nov. 10, 1994). These new provisions became effective July 3, 1995.

secondary market annual financial information and timely disclosure of certain material events.⁶⁶

Carrying through with the structure of disseminating information through multiple channels, the new provisions call for annual financial information and operating data [hereinafter referred to collectively as "annual financial information"] to be provided to each NRMSIR, as well as to any state information depository (SID) that may exist in the state in which the issuer is located.⁶⁷ Annual financial information need not be filed with the MSRB or the SEC.⁶⁸ Notices of any of the enumerated "material events" required by the provisions of paragraph (b)(5)(i)(C) are to be given to either each NRMSIR or the MSRB and to any SID.⁶⁹ Industry participants differ as to which route issuers will take, filing with the NRMSIRs or with the MSRB.⁷⁰

A number of states are reportedly considering setting up repositories. The SEC, while encouraging the formation of SIDs, has taken the position that a SID cannot act as a disseminating agent for issuers; that is, an issuer cannot file its annual financial information with its SID, and then have the SID forward copies to the NRMSIRs.⁷¹ States can, however, have a separate agent, either a state agency or a private contractor, act for the issuers and make the requisite filings with the NRMSIRs.⁷² This approach has been taken because the SEC wants to ensure that information contained in the documents is made public at the same time; it does not want a two stage release, first to the SIDs and then to the NRMSIRs.⁷³

⁶⁶*Id.* at 85,951.

⁶⁷17 C.F.R. § 240.15c2-12(b)(5)(i) (1995).

⁶⁸*Id.*

⁶⁹*Id.*

⁷⁰Lynn Stevens Hume, *More Companies Consider Serving as Repositories for Disclosure Data*, THE BOND BUYER, Dec. 2, 1994, at 1, 25.

⁷¹Lynn Stevens Hume, *SEC Provides "Road Map" for States to Create SIDs*, THE BOND BUYER, July 13, 1995, at 1, 4. As of July 1995, 17 states were considering organizing SIDs. *Id.*

⁷²*Id.*

⁷³*Id.*

There are eleven material events.⁷⁴ Adopted in large part from the American Bankers Association guidelines for disclosure by trustees⁷⁵ which were issued in 1991, the events relate to changes in credit and market risks, such as defaults, rating changes, and adverse tax actions with respect to the tax-exempt status of the securities. By its terms, the Rule does not require notice of any other event not enumerated in Rule 15c2-12(b)(5)(i)(C), although such other event might create potential liability for fraud under Rule 10b-5 if that material event was not disclosed.⁷⁶

Dealers are required to have access to information regarding these material events prior to making recommendations to customers.⁷⁷ They must establish procedures for securing notices of material events in order to monitor the events.⁷⁸

⁷⁴Section 240.15c2-12(b)(5)(i)(C) lists the material events:

- (1) Principal and interest payment delinquencies;
- (2) Non-payment related defaults;
- (3) Unscheduled draws on debt service reserves reflecting financial difficulties;
- (4) Unscheduled draws on credit enhancement reflecting financial difficulties;
- (5) Substitution of credit or liquidity providers, or their failure to perform;
- (6) Adverse tax opinions or events affecting tax-exempt status of the security;
- (7) Modifications to rights of security holders;
- (8) Bond calls;
- (9) Defeasances;
- (10) Release, substitution, or sale of property securing repayment of the securities;
- (11) Rating changes.

17 C.F.R. § 240.15c2-12(b)(5)(i)(C) (1995).

⁷⁵The guidelines were issued to assist indenture trustees in determining their obligations to disclose secondary market information. See GELFAND, *supra* note 27, § 8A:40.

⁷⁶Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,951 n.1 (Nov. 10, 1994). In its commentary, the SEC stated, "The determination of whether other events also should be the subject of notification pursuant to the information undertaking is left to the parties." *Id.* at 85,966. SEC staff have reiterated this position in speeches to industry participants, with the warning that failure to disclose a material event not specified may be a violation of the antifraud provisions of the 1934 Act. Lynn Stevens Hume, *Securities Laws May Require Issuers to Look Beyond SEC List of Events*, THE BOND BUYER, Jan. 31, 1995, at 1, 19.

⁷⁷Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,951 (Nov. 10, 1994).

⁷⁸*Id.*; 17 C.F.R. § 240.15c2-12(c), (g) (1995). The requirement of having procedures in place became effective January 1, 1996.

The reaction of the industry to the initial proposal of the rule was mild. The various interest groups had accepted the fact that some form of periodic disclosure regulation was inevitable. Prior to the issuance of the SEC's proposal in March 1994, twelve organizations, including the GFOA and the PSA, presented a joint statement on continuing disclosure, which the SEC used and considered in drafting its proposal.⁷⁹ Ten of the twelve organizations joined in presenting a collective response to the SEC's March proposal,⁸⁰ and the National Association of Bond Lawyers and the National Association of State Treasurers submitted their individual comments.⁸¹ One of the most interesting comments came from the MSRB; it urged the SEC to make any periodic disclosure voluntary, at least until documentation could be standardized.⁸²

As originally proposed in 1994, dealers would have been prohibited from selling a municipal security unless they first reviewed the annual financial information and any material events notices of the particular issuer, and then disclosed material information.⁸³ Not only would this have provided persons in the market with current information, it would have served as an incentive for issuers to comply with their agreements to supply annual financial information.⁸⁴

Municipal securities dealers were uniformly opposed to this provision on the grounds that it was procedurally impossible to implement; it would make the market less liquid; and it was, in

⁷⁹See Municipal Securities Disclosure, Exchange Act Release No. 33,742, 59 Fed. Reg. 12,759 (Mar. 17, 1994). In all, the SEC received nearly 400 comment letters responding to the SEC's proposal to amend Rule 15c2-12. Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,953 (Nov. 10, 1994).

⁸⁰Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,953 (Nov. 10, 1994).

⁸¹*Id.* at 85,953 nn.17-18.

⁸²Vicky Stamas, *MSRB Chief: Don't Require Disclosure of Periodic Data*, THE BOND BUYER, Aug. 4, 1994, at 1, 5. In the 1993 Congressional Hearings, the then-chair of the MSRB testified that the MSRB had under consideration rules to encourage voluntary disclosure by requiring underwriters to recommend to their clients, the issuers, to provide continuing disclosure to the market. 1993 Congressional Hearings, *supra* note 60, at 5. The chairman cited the restrictions of the second clause of the Tower Amendment as a major factor in the Board's decision not to mandate disclosure. *Id.* at 7. Under the Tower Amendment, the MSRB, but not the SEC, is prohibited from adopting rules that directly or indirectly require issuers to produce information. See Municipal Securities Disclosure, Exchange Act Release No. 33,742, 59 Fed. Reg. 12,759, 12,765 (Mar. 17, 1994). This is undoubtedly the reason for the regulatory shift from the MSRB to the SEC.

⁸³See Municipal Securities Disclosure, Exchange Act Release No. 33,742, 59 Fed. Reg. 12,759, 12,760-12,764 (Mar. 17, 1994).

⁸⁴*Id.*

substance, duplicative of dealers' existing obligations under the antifraud provisions of the federal securities laws and MSRB Rule G-19,⁸⁵ which requires dealers to have a reasonable basis for recommending a security to a customer.⁸⁶ The final Rule deleted this requirement and substituted the requirement that dealers have procedures for accessing information.⁸⁷

Also of concern to both the issuers and the dealers was the possible unintended consequence of creating (or deepening) a two-tier market: one for the larger, more frequent issuers for whom providing annual financial information would not be a problem (for they are likely to be already preparing and distributing such information) and the other for the small municipal issuers for whom the requirement would be more onerous. These small issuers would be faced with a choice: incur the costs to comply or have their securities even less marketable.

To deal with this potential problem, the amendments included a limited exemption for small issuers. Issuers and "obligated persons,"⁸⁸ who together have less than \$10 million of principal amount of securities outstanding, including the securities to be issued, are not required to supply annual financial information.⁸⁹ They are, however, required to

⁸⁵MSRB MANUAL, *supra* note 19, ¶ 3591 (Rule G-19).

⁸⁶See Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,951-85,954 (Nov. 10, 1994), for the SEC's description of the commentary it received on this provision of the proposed rule.

⁸⁷See *supra* text accompanying notes 77-78.

⁸⁸An "obligated person" is any person,

including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

17 C.F.R. § 240.15c2-12(f)(10) (1995). The exemption for bond insurers, issuers of letters of credit and providers of liquidity facilities was made on the grounds that annual information as to these credit issuers is already publicly available. Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,961 (Nov. 10, 1994).

Under the amended rule, annual financial information and notices of material events are to be provided for each obligated person. The issuer may or may not be an "obligated person." The term may include particular parts of the issuer, such as investment funds or a dedicated stream of revenue. For example, the investment fund involved in the Orange County financial crisis would have constituted a separate "obligated person" for any borrowings backed in whole or in part by the fund. While the type of information to be provided on an annual basis is more or less frozen in time by what has been provided in the final official statement, the persons who are obligated persons may change over time if the person no longer meets the definition or the objective criteria initially adopted.

⁸⁹17 C.F.R. § 240.15c2-12(d)(2)(i) (1995).

provide notices of material events.⁹⁰ Similarly, securities offerings of eighteen months or less are exempt from the filing requirement for annual financial information, but not from the requirement for filing notices of material events.⁹¹

There are other exemptions from the provisions of paragraph (b)(5). These exemptions mirror those applicable to primary offerings.⁹² Dealers are exempted from their obligations regarding recommendations when the securities in question were part of a primary offering (1) exempt because the dollar amount of the original offering was less than \$1 million, or (2) exempt because they were a part of a limited placement, or short-term debt, or securities "with demand provisions."⁹³ However, dealers are not exempted from their obligations under Rule 15c2-12(c) with respect to securities which have been offered under the "small issuer" exemption (less than \$10 million in aggregate principal amount of securities outstanding).⁹⁴ Thus, dealers must assure themselves as to relevant current information for such securities.

Rule 15c2-12 neither recommends language to be used in the agreement nor does it specify where the written agreement should be placed. In the months before July 1, a number of different model provisions were circulated, as well as different legal advice as to where the agreement should appear, ranging from the bond itself, the official statement, the underwriting agreement or a separate document.⁹⁵ The official statement must, however, contain a reference to the agreement and its content.⁹⁶

2. MSRB Rule G-37

At much the same time as the SEC was considering the regulation of the secondary market, the MSRB, with considerable support from the

⁹⁰17 C.F.R. § 240.15c2-12(d)(2)(ii)(B) (1995).

⁹¹17 C.F.R. § 240.15c2-12(d)(3) (1995).

⁹²17 C.F.R. § 240.15c2-12(a), (d)(1) (1995).

⁹³17 C.F.R. § 240.15c2-12(d)(4) (1995).

⁹⁴17 C.F.R. § 240.15c2-12(d)(4)(i) (1995).

⁹⁵See, e.g., Lynn Stevens Hume, *PSA Unveils Draft Language for SEC Disclosure Rules*, THE BOND BUYER, Mar. 29, 1995, at 1, 28 (discussing the PSA's models of undertakings). Separate models were drafted for each of the possible places the undertaking could be placed: one for inclusion in the indenture, one for inclusion in the bond resolution, and one for use in conduit transactions. At the same time, draft language was proposed by four major bond law firms. Under their model, the undertaking required by the rule would be placed in an independent document. Lynn Stevens Hume, *Draft Disclosure Language Pleases Some, But Not All*, THE BOND BUYER, Apr. 3, 1995, at 1, 10.

⁹⁶17 C.F.R. § 240.15c2-12(f)(3) (1995).

SEC,⁹⁷ was considering rules to combat what was perceived as an increasingly corrupt market. In particular, the SEC and the MSRB sought to eliminate the "pay-to-play" way of doing business with municipal issuers.⁹⁸

In April 1994, the controversial Rule G-37 went into effect.⁹⁹ Rule G-37 prohibits underwriters from participating in a negotiated underwriting of securities of an issuer for a two year period if the dealer or any of its professional employees contributed monies to any official of such issuer.¹⁰⁰ Quarterly reports of contributions made and municipal securities business transacted in the quarter must be filed with the MSRB.¹⁰¹ Thus, Rule G-37 operates to limit the well-established practice of underwriters making significant campaign contributions to public officials. Enforcement of Rule G-37 is through the monitoring efforts of the NASD, the SEC, and appropriate bank regulators.

The potential scope and impact of Rule G-37 is wide and, as yet, undetermined. In an interpretative release, the MSRB made it clear that there would be few exceptions to the Rule.¹⁰² For example, the restrictions operated to prohibit members of the municipal finance industry from contributing to the (albeit short-lived) presidential campaign of Governor Pete Wilson unless the members forfeited any participation in the primary negotiated securities offerings of the State of California, the largest issuer in the country.¹⁰³ The Governor petitioned the MSRB

⁹⁷See, e.g., testimony of SEC Chairman Arthur Levitt, 1993 *Congressional Hearings*, *supra* note 60, at 5 (discussing how the SEC supports MSRB efforts); see also 1993 SEC STAFF REPORT, *supra* note 9, at 32-34 (indicating the steps the SEC was taking along with the MSRB to address the problem of political influences and the staff's reasoning for letting the MSRB take the lead). The staff expressed the view that since the underwriters' disclosure to this point had been regulated by the MSRB, it made more sense to let the MSRB act in this area. *Id.*

⁹⁸1993 SEC STAFF REPORT, *supra* note 9, at 32-34.

⁹⁹The SEC approved Rule G-37 on April 7, 1994. Municipal Securities Rulemaking Board, Exchange Act Release No. 33,868, 59 Fed. Reg. 17,621 (Apr. 7, 1994). Its effective date was April 25, 1994. MSRB MANUAL, *supra* note 19, ¶ 3681 (1995).

¹⁰⁰Rule G-37(b), MSRB MANUAL, *supra* note 19, ¶ 3681. The rule also applies to political action committees of dealers and municipal finance professionals. *Id.* A limited exception is made for contributions of not in excess of an aggregate of \$250 per official per election made by any municipal finance professional where the municipal finance professional is entitled to vote for such official. *Id.* See also Thomas G. Hilborne, Jr., *Rule G-37: The "Pay to Play" Rule and Its Impact on the Municipal Securities Industry*, 26 URB. LAW. 957 (Fall 1994) (discussing the Rule, its background, and its development).

¹⁰¹MSRB MANUAL, *supra* note 19, ¶ 3681 (Rule G-37(e)(ii)).

¹⁰²See MSRB Interpretations, MSRB MANUAL, *supra* note 19, ¶ 3681, at 5423-36.

¹⁰³Lynn Stevens Hume, *California Governor Wilson Seeks Relief From MSRB Rule G-37*, THE BOND BUYER, May 10, 1995, at 1, 32.

for an exemption from the Rule, but was denied.¹⁰⁴ Governor Wilson also argued that if Rule G-37 applied to him, the Rule applied to President Clinton because the President named persons to a fiscal monitoring board for Washington, D.C. The MSRB ruled that Rule G-37 did not apply to federal officials.¹⁰⁵

While the reform had the solid support of the SEC and municipal securities dealers (many of whom, while the proposal was pending, agreed voluntarily not to make political contributions),¹⁰⁶ issuers, whose officials would be negatively affected, were not as keen. In fact, the enactment of Rule G-37 has served to focus issuers' dissatisfaction with the MSRB, bringing calls for more issuer representatives on the Board and more open meetings.¹⁰⁷ Rule G-37 was also opposed strongly by minority and female-dealer firms on the grounds that the Rule secures the existing "old boy" network of financiers and leaves the newcomers effectively out of the competition.¹⁰⁸

Finally, the Rule was challenged in the courts by a municipal securities dealer, on the grounds that Rule G-37 unconstitutionally restricts freedom of speech of dealers and violates the Tenth Amendment.¹⁰⁹ The U.S. Court of Appeals, D.C. Circuit, however, held that Rule G-37 was constitutional.¹¹⁰ The court did discuss with skepticism the relevance of political contributions to the interests of investors.¹¹¹ The plaintiff, with the support of the National Association of Bond Lawyers, petitioned the U.S. Supreme Court and was denied in April of 1996.¹¹² Also of importance, the court rejected the argument of

¹⁰⁴Lynn Stevens Hume, *Wilson Must Abide by Rule G-37, MSRB Informs Campaign Counsel*, THE BOND BUYER, June 1, 1995, at 1, 7.

¹⁰⁵*Id.*

¹⁰⁶During the period between the proposal of Rule G-37 and its final approval, over 50 firms agreed to support a voluntary ban on contributions sponsored by the PSA. Charles Gasparino, *MSRB's Clapp Sees Continued Voluntary Ban Despite Imminent Arrival of Group's Rule G-37*, THE BOND BUYER, Mar. 8, 1994, at 1, 8.

¹⁰⁷See, e.g., Vicky Stamas, *GFOA Panel Votes to Send Letter Criticizing Secrecy of MSRB Meetings*, THE BOND BUYER, June 7, 1994, at 9.

¹⁰⁸Brad Altman, *Minority Firms, Not "Pay to Play" Are G-37's Target, Treasurer Says*, THE BOND BUYER, Aug. 31, 1994, at 1, 4; Sharon R. King, *Tindell Pans MSRB's Position on Blacks at Civil Rights Probe*, THE BOND BUYER, Sept. 22, 1994, at 1, 24. In response to criticisms of the make-up of the Board, the current chair of the Board is a woman (the first to be chair); and the Board has its first minority member (also a woman).

¹⁰⁹*Blount v. SEC*, 61 F.3d 938 (D.C. Cir. 1995), *cert. denied*, 116 S. Ct. 1351 (1996). See also Hilborne, *supra* note 100 (discussing the theory and development behind the rule).

¹¹⁰*Blount*, 61 F.3d at 949.

¹¹¹*Id.* at 947-48.

¹¹²*Blount v. SEC*, 116 S. Ct. 1351 (1996).

the SEC and MSRB that Rule G-37 was a private rule of self-regulatory organizations, and held that it was a government rule.¹¹³

Enforcement of the Rule is mainly through the offices of the NASD, which, at least at the regional level, seem to take a less stringent approach to violations than does the MSRB.¹¹⁴ A recent survey conducted by *The Bond Buyer* revealed that a number of firms had failed to comply with the filing requirements of Rule G-37.¹¹⁵

The MSRB has also enacted another rule, Rule G-38,¹¹⁶ effective March 18, 1996, to require disclosure of any arrangements with other persons to assist the dealer in securing an issuer's securities business. The proposed rule first requires that all arrangements with "consultants" be in writing, specifying the services to be performed and the terms of payment, and be entered into prior to the performance of any services.¹¹⁷ Second, the existence of such arrangements must be disclosed in writing to the issuer.¹¹⁸ Third, quarterly reports are required to be filed with the MSRB which disclose all arrangements entered into, even if the dealer was ultimately unsuccessful.¹¹⁹

¹¹³*Blount*, 61 F.3d at 941.

¹¹⁴In a recent examination of a brokerage firm's violation of Rule G-37, where a member of the firm made a large political contribution to the campaign of George Pataki for Governor of New York, and then participated in an offering for a New York state agency, the NASD Local District Business Conduct Committee did not impose sanctions. Lynn Stevens Hume & Karen Pierog, *NASD Committee Calls Firm Reckless Over G-37*, THE BOND BUYER, Oct. 5, 1995, at 1, 21; Lynn Stevens Hume, *Lawyer Says G-37 Ruling Shows Up Flaw in Process*, THE BOND BUYER, Oct. 10, 1995, at 1, 4. The dealer argued that the contribution had been made on behalf of the dealer's wife and was unintentional. *Id.* Both the MSRB and executive committee of the NASD indicated that the decision was too lenient. *Id.* The NASD has announced it will increase its enforcement efforts vis-à-vis municipal securities market. Michael Stanton, *NASD Head: Restructuring Likely to Intensify Oversight*, THE BOND BUYER, Nov. 22, 1995, at 1, 3. More recently, the SEC censured the NASD for failure to enforce Rule G-37. The NASD again agreed to increase its enforcement efforts and is creating a post for a municipal compliance expert. Lynn Stevens Hume, *NASD to Get Compliance Guru for Boost in Muni Enforcement*, THE BOND BUYER, Aug. 13, 1996, at 1, 4; Lynn Stevens Hume, *SEC Slams NASD as Failing to Enforce G-37 Adequately*, THE BOND BUYER, Aug. 9, 1996, at 1, 7.

¹¹⁵Under Rule G-37, quarterly reports are required if the dealer did any negotiated underwritings of municipal securities or made any campaign contributions or both during the quarter. MSRB MANUAL, *supra* note 19, ¶ 3681 (Rule G-37(e)). *The Bond Buyer* survey found a gap between the number of negotiated underwritings reported in 1995 and the number of firms making Rule G-37 quarterly reports. Lynn Stevens Hume, *Dozen of Firms are Not Complying with Rule G-37*, THE BOND BUYER, Aug. 25, 1995, at 1, 28.

¹¹⁶MSRB MANUAL, *supra* note 19, ¶ 3686, at 5481 (1996).

¹¹⁷*Id.*

¹¹⁸*Id.*

¹¹⁹*Id.*

The purpose of Rule G-38 is to discourage a wide variety of financial arrangements, including finder's fees and kick-backs, which are often involved in the marketing of municipal securities. The MSRB and the SEC argue that these practices increase the issuer's costs and taint the market.¹²⁰

As with Rule G-37, the proposed Rule G-38 was quite controversial.¹²¹ The GFOA, PSA, and other groups opposed the rule maintaining that it is not needed — that the concerns could be handled with an amendment to Rule G-37.¹²² The National Association of Bond Lawyers objected to the scope of the term "consultants," which potentially brings lawyers and accountants under the rule's limits.¹²³ In response to the criticisms, the MSRB withdrew its initial proposal and, in September 1995, filed a revised proposed rule that has a narrower definition of "consultants."¹²⁴

Finally, the American Bar Association and the Association of the Bar of the City of New York are looking into rules governing campaign contributions by lawyers.¹²⁵

In terms of enforcement actions against pay-to-play activities, the SEC staff reported in May 1995 that the SEC had almost two dozen ongoing enforcement investigations.¹²⁶ In recent months, the SEC has reached multi-million dollar settlements against dealers, including Lazard Freres and Merrill Lynch.¹²⁷

¹²⁰MSRB MANUAL, *supra* note 19, ¶ 10,658, at 11,348 (Rule G-38).

¹²¹Lynn Stevens Hume, *MSRB Offers Rule Defining Consultants Narrowly*, THE BOND BUYER, Sept. 29, 1995, at 1, 29.

¹²²*Id.*

¹²³*Id.*

¹²⁴*Id.* The new proposal made clear that the term "consultant" did not cover attorneys or accountants hired to assist in a particular municipal securities transaction unless that assistance takes the form of acting as a "finder." *Id.*

¹²⁵The Association of the Bar of the City of New York has recommended adoption of a rule prohibiting political contributions and the ABA is studying the question. Lynn Stevens Hume, *NABL Seeks Lawyers' Views On Pay-to-Play Policy, Issues*, THE BOND BUYER, Oct. 25, 1995, at 3.

¹²⁶Lynn Stevens Hume, *Bonds' Risk of Being Taxed Must be Disclosed, SEC Says*, THE BOND BUYER, May 12, 1995, at 1, 28 (reporting on a statement made at a meeting of the National Association of Bond Lawyers by an assistant director of the SEC enforcement division). In September 1995, the director of the SEC Office of Municipal Securities stated that the office had more investigations underway than the number reported earlier in May 1995. Four of the five lawyers in the new division have experience in enforcement. Lynn Stevens Hume, *SEC Activities in Enforcement for Municipals Have Increased*, THE BOND BUYER, Sept. 21, 1995, at 1, 23.

¹²⁷See Wayne, *supra* note 4, at D1, D4, for discussion of the two large settlements and other enforcement actions pending at the SEC. Efforts are being stepped up by the other regulators. For example, the Office of the Comptroller of the Currency is investigating the

3. Other Regulation

In light of the losses incurred by state and local governments in derivative securities, the issue of suitability or "know thy customer" rules were reviewed by a number of bodies, including the NASD and GFOA, to determine the appropriate standard for sales of securities to institutions: in particular, state and local governments, as opposed to individuals. These losses raised concern about the duties owed to such institutions by securities dealers. A new NASD rule makes clear that dealers have an obligation of making sure securities are suitable for the customer, without regard to whether the customer is a person or an institutional account.¹²⁸ Recognizing, however, that institutions may have better capabilities for evaluating risks, the rule permits dealers to weigh this factor in determining suitability.

PART TWO — HOW THE SYSTEM WORKS

The bankruptcy and default of Orange County provides an opportunity to examine how well the current system of regulation operates. This part first discusses what information exists as to the effects of the enactment of federal securities regulations on municipal securities disclosure, and then, turns more specifically to analyze the disclosure made by Orange County as an issuer in its public offerings prior to its filing for bankruptcy.

A. *Studies/Cases*

There is very little in the way of empirical studies of the quality of municipal disclosure since the adoption of Rule 15c2-12 in 1989.

possible violation of Rule G-37 by First Tennessee Bank because two top executives were listed on invitations for a fundraiser for the Governor as vice chairs of the dinner. *See supra* note 114 and accompanying text. The Justice Department successfully prosecuted a municipal securities consultant, involved in "pay-to-play" activities, for violations of the antifraud disclosure provisions. Mark Ferber was found guilty of 58 counts. Christina Pretto & Angela Shah, *Jurors Find Ferber Guilty 58 Times Over*, THE BOND BUYER, Aug. 12, 1996, at 1.

¹²⁸NASD RULES OF FAIR PRACTICE art. III, sec. 2; *see* Joanne Morrison, *GFOA Says Sales Practice Rules Improved But Need Strengthening*, THE BOND BUYER, May 18, 1995, at 3; Joanne Morrison, *NASD Announces Rules That Place Suitability Burden on Broker-Dealers*, THE BOND BUYER, July 18, 1995, at 1, 27; *see also* Richard Y. Roberts, *Reforming the Municipal Securities Market*, 15 MUN. FIN. J. 1, 3-4 (Summer 1994) (discussing the recent increase in the number of individual investors in the municipal securities market). The SEC approved the NASD rule in August 1996. Joanne Morrison, *SEC Says Yes to Rules Putting Onus on Dealers*, THE BOND BUYER, Aug. 22, 1996, at 1.

Most market participants, including the SEC and the MSRB, believe that the Rule has been effective and are reasonably satisfied with the level of disclosure in the primary market. However, one area in which municipal issuers traditionally have been weak is the meaningful disclosure of financial information. There is evidence that local governments have improved their financial reporting, although there still exists the problem of lack of uniform reporting practices.¹²⁹ The MSRB response to the SEC's proposal to amend Rule 15c2-12 to call for periodic disclosure cited the lack of uniformity in the presentation of financial information as the major reason for its position that the program for secondary disclosure should be voluntary, at least initially.¹³⁰

There are no reported cases relating to the enforcement of Rule 15c2-12 by the SEC. Although dealers complain that issuers are laggard in providing underwriters sufficient quantities of their official statements to meet their obligations,¹³¹ participants in the market have noted that, until very recently, efforts to enforce the Rule and the MSRB rules, generally, have been all but non-existent.¹³² The SEC annual reports for the years 1990-1994 list no significant fraud cases against municipal issuers or dealers. A list of fraud cases appended to the 1993 Staff Report consisted of eight cases, all brought against dealers; none of these cases involved Rule 15c2-12 and only one related to misrepresentations made in connection with primary offerings.¹³³ As previously discussed, SEC enforcement actions have greatly increased during Chairman Levitt's tenure at the Commission.¹³⁴

¹²⁹Arthur Allen & George D. Sanders, *Measuring Progress: A Reexamination of Municipal Accounting Disclosure*, 15 MUN. FIN. J. 32, 47 (Spring 1994) (discussing a survey, which found that accounting reports had improved but that there was little change in financial statement disclosures). In particular, the percentages of cities disclosing specific subject items remained much the same. *Id.*

¹³⁰Stamas, *supra* note 82, at 5.

¹³¹Ann Brashear, *SEC Interpretive Release and Proposed Rules on Municipal Disclosure*, 15 MUN. FIN. J. 1, 6 (Fall 1994); Southern Municipal Finance Society, *Comprehensive Program for Market, Regulatory and Legislative Action*, reprinted in 12 MUN. FIN. J. 68, 84 (Spring 1991).

¹³²*See, e.g.*, Southern Municipal Finance Society, *supra* note 131, reprinted in 12 MUN. FIN. J. at 83 (recommending modification of Tower Amendment to deal with "lax" enforcement of MSRB rules dealing with disclosure).

¹³³*See* 1993 SEC STAFF REPORT, *supra* note 9, app. D, at 2.

¹³⁴*See supra* notes 4, 6 & 128. The increase in SEC activity has been so great in the last two years that municipal securities issuers and dealers have become alarmed and are beginning to resist the SEC's efforts. Lynn Stevens Hume, *PSA Warns SEC on New Standards in Denver Bond Probe*, THE BOND BUYER, Jan. 18, 1996, at 1, 32.

B. *Orange County*

The ink was barely dry on the SEC's 1994 amendment to Rule 15c2-12 when Orange County, California announced that its \$20 billion investment pool (Investment Pool) had incurred \$1.7 billion in investment losses. The Investment Pool was made up of funds from 187 local governments, in addition to those of the County. All but approximately \$8 billion of the \$20 billion were borrowed funds.¹³⁵

The subsequent filing for bankruptcy on December 6, 1994 by Orange County, one of the wealthiest counties in the United States,¹³⁶ and the Investment Pool raises issues concerning the adequacy of disclosure in the primary market and the trading practices of municipal securities dealers.

Orange County's fiscal crisis also poses some very familiar questions. How was it that no one knew of the extent of Orange County's losses, despite two public offerings of securities by the County and a number of public offerings by other investment pool investor-local governments, within six months of the filing for bankruptcy? In June and July of 1994, Orange County and the other entities in the Investment Pool issued \$900 million in debt.¹³⁷ Orange County's second public offering was as late as September 1994.¹³⁸ There has been testimony before state officials that the losses existed and were known by Orange County's bond counsel at least by October.

¹³⁵See James Sterngold, *Orange County Bankruptcy: The Poor Feel the Most Pain*, N.Y. TIMES, Dec. 5, 1995, at A1; G. Bruce Knecht, *Derivatives Lead to Huge Loss in Public Fund*, WALL ST. J., Dec. 2, 1994, at A3 (reporting on the announcements of Orange County's losses). See also Arthur Levitt, *The Municipal Bond and Government Securities Market*, 16 MUN. FIN. J. 6, 8-13 (Summer 1995) (discussing the nature of the investment pool participants and the nature of the pool's investments); *The Municipal Securities Markets: Hearings Before the Comm. on Banking and Financial Services*, 104th Cong., 2d Sess. (July 26, 1995), 1995 WL 441680 (SEC) (testimony of Paul S. Maco, Director, Office of Municipal Securities, U.S. Securities and Exchange Commission) (discussing the effect of Orange County's bankruptcy on the municipal securities market and a step-by-step analysis of the events and decisions which led to the County's bankruptcy).

¹³⁶Orange County has a population of 2.6 million where the medium income is 60% above the national average. Its economy is the 28th largest in the world. Michael Utley, *One Year Later, Crisis Looms Large for the Market, Not for the Public*, THE BOND BUYER, Dec. 6, 1995, at 1, 6.

¹³⁷Jeffrey Taylor, *SEC is Probing Orange County on Two Fronts*, WALL ST. J., Dec. 7, 1994, at A3.

¹³⁸Official Statement, County of Orange, California, Dated Sept. 26, 1994, \$320,040,000 Taxable Pension Obligation Bonds, Series 1994 A (\$209,840,000) and Series 1994 B (\$110,200,000) [hereinafter September Official Statement].

Certainly, the County's financial advisors, its underwriters, and the rating agencies should have been aware of the size of Orange County's portfolio invested in high risk derivative securities. Consequently, how could Orange County's securities be rated AA-Minus by Standard & Poors and AA by Moody's right up to the time of bankruptcy?¹³⁹ To what extent were the dealers, in particular Merrill Lynch, who sold derivative securities to Orange County, violating their fiduciary duties as financial advisors, as well as the MSRB's suitability rules? To what extent were state and local governments, which invested large amounts of money, sophisticated investors in terms of the application of these rules?

These questions go to the heart of municipal securities regulation, without regard to whether the County is ultimately found to have violated the antifraud provisions of Rule 10b-5. An uninformed market and "A" ratings up until disaster is characteristic of major municipal securities defaults, namely, New York City in 1974 and WPPSS in 1988.¹⁴⁰

1. Background

The investment of the local governments' pooled funds was in the hands of one elected official, the Treasurer of Orange County. For over twenty years, the Treasurer, Robert Citron, managed the Investment Pool essentially without supervision. Beginning in the 1980s, Citron began investing in what are known as derivative securities and in reverse repurchase agreements.

Derivative securities can be broadly defined as "financial instruments whose value is derived from or based upon the value of another security or on the level of an index."¹⁴¹ At the time of the bankruptcy, Orange County had approximately 42.5% of the Investment Pool's portfolio of \$20 billion invested in derivatives, of which 80% consisted of "inverse floaters."¹⁴² Inverse floaters are volatile securities

¹³⁹Asked to explain these ratings, both rating agencies said that they were aware of some losses, but that the County had not told them of the severity of the losses. Charles Gasparino, *Rating Agencies Scheduled to See County Officials*, THE BOND BUYER, Dec. 9, 1994, at 1, 7; Leslie Wayne, *Municipal Bond Regulation Debated at House Hearing*, N.Y. TIMES, July 27, 1995, at D4.

¹⁴⁰See, e.g., WPPSS SEC REPORT, *supra* note 2, and NEW YORK SEC REPORT, *supra* note 2, for a discussion of the events and circumstances of these two fiscal crises.

¹⁴¹Gary Gray & Patrick Cusatis, *Understanding and Valuing Municipal Derivative Securities*, 14 MUN. FIN. J. 1, 2 (Summer 1993). See also Levitt, *supra* note 135, at 10-12 (explaining risks inherent in investing in derivatives and reverse repurchase agreements).

¹⁴²Knecht, *supra* note 135, at A3.

whose yield goes down when the market interest rate goes up and vice versa.¹⁴³

Orange County borrowed money and encouraged other County units, such as school districts, to do so, by issuing taxable notes to invest in derivatives. In fact, the County had issued \$600 million of taxable notes for this purpose in July 1994. These securities were not tax exempt because municipal securities issued for the purpose of arbitraging interest rates do not qualify for the federal tax exemption.¹⁴⁴

The Investment Pool did well in earlier years, providing an average yield of over 10.1% for fifteen years.¹⁴⁵ However, beginning in 1994, market interest rates started to go up. Because the securities held by Orange County were inversely tied to the market interest rates, their value plummeted. Mr. Citron resigned on December 4, 1994, and has since pleaded guilty to defrauding investors and misappropriating government funds in violation of California law.

Both Orange County and the Investment Pool filed for bankruptcy.¹⁴⁶ These filings allowed the County to hold off both the bondholders, as its creditors, and other local government investors, by preventing other pool members from immediately withdrawing funds from the Investment Pool. In May 1995, Orange County and over 100 local governments agreed to a settlement in which the County would ultimately give the local government investors 100¢ on the dollar, but only 77¢ immediately.¹⁴⁷ Bondholders argued that this settlement gave

¹⁴³"Inverse floaters are, in effect, another way to borrow at short-term rates and invest at long-term rates." Laura Jereski & Thomas T. Vogel, Jr., *Orange County Borrowed \$1 Billion Even as its Investment Losses Piled Up*, WALL ST. J., Dec. 5, 1994, at A3.

¹⁴⁴An arbitrage bond is one where the proceeds are invested in obligations having a yield higher than the yield on the bonds. I.R.C. § 148(a) (1988).

¹⁴⁵Knecht, *supra* note 135, at A4.

¹⁴⁶The filing for bankruptcy by Orange County under Chapter 9 is by far the largest municipal bankruptcy. In 1991, Bridgeport, Connecticut, attempted to file for bankruptcy but the city never went through the process because of state opposition.

The Orange County filing raises the question of the meaning of the "full faith and credit" guaranty on municipal general obligation bonds. The concept that the issuer will use all of its resources, i.e., taxing power, to repay its guaranteed debt, underlies the traditional municipal securities market. Doubts concerning the guaranty undercut the credit-worthiness of these bonds. In July 1995, a federal district court overruled the bankruptcy court and held that Orange County could not ignore its obligations to set aside revenues which secured tax and revenue anticipation notes ("Tans" and "Rans") previously issued. Lynn Stevens Hume, *Market Lauds Court Ruling on Orange County Notes*, THE BOND BUYER, July 17, 1995, at 36. Tans and Rans are known as "double barrel" securities in that they are general obligation securities and provide the noteholders with a lien on the issuer's revenues as they are received.

¹⁴⁷Michael Utley, *Judge Rules Pool's Bankruptcy Filing Invalid, But Impact is Mostly Academic*, THE BOND BUYER, May 26, 1995, at 36.

the governments a preference over bondholders' claims on the pooled funds.¹⁴⁸ Subsequent to the disbursement of funds from the pool to its government investors, a bankruptcy judge ruled that the Investment Pool, as a separate entity, was not a "local government" under Chapter Nine of the Bankruptcy Act and not entitled to its protection.¹⁴⁹ By that time, the settlement money had already been disbursed.¹⁵⁰

2. Misery Loves Company

The magnitude of the losses and the subsequent filing for bankruptcy landed Orange County in the spotlight. But, it was far from the only government with investment losses from derivative securities. Local governments in Maryland, Ohio, and Wisconsin, to name a few, lost substantial amounts of money through derivative holdings.¹⁵¹ For example, the State of Wisconsin's pooled investment fund, with funds from over 1,000 local governments in addition to the State, lost \$95 million due to its investment in derivatives.¹⁵²

In a situation very similar to that of Orange County, the state of West Virginia is currently seeking to recover part of its almost \$300 million of losses against the investment bankers who sold the fund derivatives.¹⁵³ Six dealers, all major investment banking firms, settled by paying the state a total of \$28 million.¹⁵⁴ Morgan Stanley refused to settle and was sued by West Virginia.¹⁵⁵ This lawsuit was carefully monitored by the municipal securities market. The state was successful

¹⁴⁸Hume, *supra* note 146, at 36; Testimony of Paul Maco, *supra* note 135, app. A n.25.

¹⁴⁹Utle, *supra* note 147, at 36.

¹⁵⁰*Id.*

¹⁵¹Lynn Stevens Hume, *County Lawsuit Seeks to Regain Funds Invested in Derivatives*, THE BOND BUYER, Aug. 24, 1994, at 1 (entire portfolio of Charles County, Maryland, was invested in derivatives sustaining \$30 million of losses); Karen Pierog, *Derivatives Losses in Wisconsin Pool May Induce Towns to Bring Lawsuit*, THE BOND BUYER, Mar. 27, 1995, at 1 [hereinafter Pierog, *Derivative Losses*] (\$95 million losses related to derivatives); Karen Pierog, *Ohio Treasurer Urges Ban on Municipal Investment Pools, Use of Derivatives*, THE BOND BUYER, Jan. 4, 1995, at 2 (Cuyahoga County had losses of \$114 million connected with leveraged investments); Donald Yacoe, *Greenwood County, S.C., Treasurer Quits After Fund Suffers Derivatives Losses*, THE BOND BUYER, Dec. 15, 1994, at 1 (paper losses to an \$8.4 million trust fund).

¹⁵²Pierog, *Derivative Losses*, *supra* note 151, at 1.

¹⁵³Leslie Wayne, *Big Risks, Big Losses, Big Fight*, N.Y. TIMES, Apr. 23, 1995, sec. 3, at C1, C16.

¹⁵⁴*Id.* at C16.

¹⁵⁵*Id.*; see Joanne Morrison, *Judge Reiterates Morgan is Liable for State's Losses*, THE BOND BUYER, Mar. 7, 1995, at 1, 5.

in the lower court in obtaining a judgment of \$56 million.¹⁵⁶ Morgan Stanley was found liable on the ground that the sale of the high risk securities violated state statutes that specify the types of investments local governments are authorized to purchase.¹⁵⁷ On appeal, the West Virginia Supreme Court reversed and remanded on the basis that the instructions to the jury were wrong.¹⁵⁸ To the extent the jury found Morgan Stanley liable, the jury would determine whether the \$56 million in losses should be offset by the gains made by the fund in trades done through Morgan Stanley. Morgan Stanley and West Virginia finally agreed to a settlement of \$20 million.¹⁵⁹

As with Orange County, the investment of the West Virginia fund was left under the control of one individual.¹⁶⁰ That person was Kathryn Lester, who had little, if any, formal financial background.¹⁶¹ Made director of investments in 1983, she had control over the \$2.2 billion fund.¹⁶² Prior to her employment by West Virginia, Ms. Lester had been a secretary in a bank in Washington.¹⁶³ There she became involved in government bond trading and was appointed as an assistant bond trader at the bank.¹⁶⁴ She was at that job from 1981 to 1983.¹⁶⁵ In 1983 she moved to West Virginia and obtained a job in the State Treasurer's office.¹⁶⁶ A *New York Times* article about West Virginia's woes recounts that "[s]ince the director of investments knew nothing about bonds, she started to educate him."¹⁶⁷ When the director resigned at the end of 1983, Ms. Lester was appointed to succeed him.¹⁶⁸

Like Mr. Citron in Orange County, Ms. Lester was encouraged by her own initial success to invest more and more in derivatives.¹⁶⁹ When these high rollers were successful, no one looked at the risks inherent in

¹⁵⁶Wayne, *supra* note 153, at C16.

¹⁵⁷*Id.*

¹⁵⁸Joanne Morrison, *Morgan Stanley, West Virginia Reach \$20 Million Settlement*, THE BOND BUYER, Aug. 15, 1996, at 1, 6; Joanne Morrison, *West Virginia's Top Court Won't Rehear Morgan Case*, THE BOND BUYER, July 20, 1995, at 1, 5.

¹⁵⁹Morrison, *Morgan Stanley*, *supra* note 158, at 1.

¹⁶⁰Wayne, *supra* note 153, at C1.

¹⁶¹*Id.* at C16.

¹⁶²*Id.* at C1.

¹⁶³*Id.* at C16.

¹⁶⁴Wayne, *supra* note 153, at C16.

¹⁶⁵*Id.*

¹⁶⁶*Id.*

¹⁶⁷*Id.*

¹⁶⁸Wayne, *supra* note 153, at C16.

¹⁶⁹*Id.*

their investment policies.¹⁷⁰ The responses of Orange County and West Virginia are also quite similar. As with West Virginia and Ms. Lester, Orange County and Mr. Citron, specifically, put much of the blame on their investment banking firm, Merrill Lynch¹⁷¹ and sued the firm for \$2 billion for its losses.¹⁷² Unlike the West Virginia case against Morgan Stanley, in 1979 Mr. Citron lobbied for, and obtained, a change in California's applicable statute to allow local governments to invest in certain type of derivatives.¹⁷³ Therefore, the basis of Orange County's suit was inadequate disclosure of risks and violations of Merrill Lynch's fiduciary duties as financial advisor to the County.¹⁷⁴ In the days immediately after the announcement, the SEC began an investigation. In addition, a number of lawsuits have been filed by bondholders against Orange County and Merrill Lynch.¹⁷⁵

Orange County and its local governments had \$800 million in short-term notes maturing in the period between June — August 1995.¹⁷⁶ The options open to Orange County were limited in that California constitutional restraints on raising property taxes eliminated the prospect of increasing property taxes to raise money to pay its obligations. Instead, Orange County proposed to raise its sales tax one-half of 1% in order to avoid default.¹⁷⁷ A consensus against new taxes, however, continued to color the Orange County taxpayers' response to the financial straits of the government; the tax was not approved.¹⁷⁸ Subsequent to the vote, Orange County came to an agreement with the noteholders to extend maturity of the notes coming due in 1995 for one year, in exchange for additional interest and a bonus payment upon maturity.¹⁷⁹

¹⁷⁰*Id.*

¹⁷¹Leslie Wayne, *Merrill Lynch Faces a Barrage of Orange County Lawsuits*, N.Y. TIMES, Dec. 5, 1995, at D1.

¹⁷²*Id.*

¹⁷³The change in the state statute added reverse repurchase agreements as authorized investments. The list was expanded again in 1992 to include a number of other structured obligations. Levitt, *supra* note 135, at 18.

¹⁷⁴See Wayne, *supra* note 171, at D1.

¹⁷⁵There are over 10 lawsuits against Merrill Lynch alone. Various actions against Orange County are tied up in the bankruptcy proceedings. See Wayne, *supra* note 171, at D1.

¹⁷⁶Michael Utley, *Note Default Sends Tremors Through Municipal Market*, THE BOND BUYER, July 10, 1995, at 1, 2.

¹⁷⁷*Id.*

¹⁷⁸Sixty-one percent of voters voted against the proposed sales tax. *Id.*

¹⁷⁹The roll-over agreement was approved by 98% of noteholders on July 10, 1995. Michael Utley, *Creditors Approve One-Year Rollover, But Raters Deem Notes in Default*, THE BOND BUYER, July 11, 1995, at 1. There are approximately 800 noteholders, 90% are held by 20 institutional investors; 10% are held by retail investors. Michael Utley, *Noteholders Will Vote Today on One-Year Rollover Plan*, THE BOND BUYER, July 7, 1995, at 1, 28.

In the aftermath of the referendum on the sales tax, an Orange County chief executive, who had been appointed in December to head the County's efforts to right its troubled financial affairs, resigned.

Technically, the declaration of bankruptcy and renegotiation of the terms of the notes placed Orange County in default.¹⁸⁰ County officials have argued that the agreement reached with the noteholders prior to an actual failure to pay saved it from being considered in default.¹⁸¹ Market participants, particularly the rating agencies, rejected this argument, and continue to rate the County's securities as being in default.¹⁸²

How well did the existing system function? Clearly, there had been a loss in market value for all holders of the County's debt. The losses of the Investment Pool, the bankruptcy, and subsequent agreements to extend maturity, would all be "events" to be reported under the new Rule 15c2-12(b)(5)(C).¹⁸³ Although the County had two public offerings in the six month period preceding the public announcement of the Investment Pool's losses in December 1994,¹⁸⁴ review of the official statements for these offerings yields little information about the Investment Pool at all. Certainly, there was no mention or discussion of any experienced losses even though the facts show that increased losses began in spring 1994.¹⁸⁵

¹⁸⁰Utley, *Creditors Approve One-Year Rollover*, *supra* note 179, at 1.

¹⁸¹*Id.* at 7.

¹⁸²*Id.*

¹⁸³17 C.F.R. § 240.15c2-12(b)(5)(i)(C).

¹⁸⁴See September Official Statement, *supra* note 138; Official Statement, County of Orange, California, Dated July 1, 1994, \$600 Million 1994-95 Taxable Notes [hereinafter July Official Statement].

¹⁸⁵Questions about the strength of the Pool's investments surfaced in the spring of 1994. In April 1994, Citron told *The Wall Street Journal* that he had been forced by rising interest rates to meet \$140 million of "collateral calls." Knecht, *supra* note 135, at A4. In May 1994, SEC officials from the Los Angeles office met with the Orange County Treasurer concerning the Pool's heavy investment in leveraged securities. Jeffrey Taylor, *SEC Probed Orange County Investments Just Months Before the Fund's Collapse*, WALL ST. J., Dec. 16, 1994, at A2.

3. Review of Disclosure Documents

- a. *Official Statement, Dated July 1, 1994, \$600 Million Taxable Notes, Rated by Standard and Poor's A-1+ by Moody's P-1*

1. Terms of Notes

The taxable notes were general obligation notes, payable from the County's general revenue fund,¹⁸⁶ which were to mature on July 10, 1995.¹⁸⁷ Proceeds of the notes were placed in a "Repayment Fund."¹⁸⁸ The Repayment Fund was to be invested in the County's Investment Pool.¹⁸⁹ Interest on the investment of the Repayment Fund above the interest payable on the notes went into the County's general fund.¹⁹⁰ The only purpose of this offering was to borrow money to arbitrage the difference in interest rates between the County's borrowing costs and the yield on the Investment Pool, a technique known as leveraging.¹⁹¹ This use of borrowed funds increases the riskiness of an investment because it magnifies the consequences of an interest rate drop on the investments vis-à-vis the borrower's interest obligations on the borrowed funds.¹⁹² It has been estimated that leverage used with inverse floaters tripled the riskiness of Orange County's investments.¹⁹³

2. Participants

The issuance was underwritten by Merrill Lynch in a negotiated offering.¹⁹⁴ Orange County was also advised by Leifer Capital, Inc., "financial and marketing specialists,"¹⁹⁵ which was represented by the law firm of Brown and Wood.¹⁹⁶ There is no mention of underwriters counsel, but Brown and Wood was also Merrill Lynch's general outside counsel. In the aftermath of the disclosure of losses, it appears that

¹⁸⁶July Official Statement, *supra* note 184, at cover page.

¹⁸⁷*Id.*

¹⁸⁸*Id.* at 2-3.

¹⁸⁹*Id.* at 9-10.

¹⁹⁰July Official Statement, *supra* note 184, at 3.

¹⁹¹Laura Jereski & Thomas T. Vogel, Jr., *Orange County Borrowed \$1 Billion Even as Its Investment Losses Piled Up*, WALL ST. J., Dec. 5, 1994, at A3.

¹⁹²*Id.*

¹⁹³*Id.*

¹⁹⁴*Id.* at A4.

¹⁹⁵July Official Statement, *supra* note 184, at 3.

¹⁹⁶*Id.*

Merrill Lynch employees in its Los Angeles office contributed \$1,000 each to Mr. Citron's reelection campaign in June 1994, in contravention of MSRB Rule G-37.¹⁹⁷

3. Disclosure

The official statement contained a separate section for a description of the Investment Pool, as well as a separate section on "Special Risks." The description of the pool disclosed that its portfolio was valued at original cost, not marked to market, and that the portfolio also consisted of:

a mixture of various fixed and floating rate securities. From time to time, a significant portion of these securities are pledged with respect to reverse repurchase agreements authorized by law. The price and income volatility of the above securities is greater than standard fixed income securities and may serve to increase the volatility of the County Investment Pool's return and market value in various interest rate environments as well as serve as a hedge in other interest rate environments.¹⁹⁸

The section also contained a tabulation of the pool's returns for the FY 1990-91 to March of FY 1993-94. The table shows a decline from 8.52% for FY 1992-93 to 7.80% for FY 1993-94 through March 31, 1994.¹⁹⁹ There was nothing more specific concerning any losses already incurred, collateral calls, or decreases in cash as a result of collateral calls. The magnitude of its holdings of derivative securities was not mentioned. The section covering "investment risk" under the Special Risks section stated:

The County intends to invest moneys held in the Repayment Fund in the County Investment Pool. If the County Investment Pool suffers an overall investment loss on the portfolios, Pledged Moneys may be insufficient to pay the

¹⁹⁷*Three Merrill Employees Gave in County Election*, WALL ST. J., Dec. 9, 1994, at A6. See MSRB MANUAL, *supra* note 19, ¶ 3681 (Rule G-37).

¹⁹⁸July Official Statement, *supra* note 184, at 10. Valuing investments at original cost means gain and losses are not reflected until securities are sold. *Id.* at 9. Governmental Accounting Standards Board's standards do not specify a method for measuring value.

¹⁹⁹*Id.* at 10.

principal of and interest on the Notes. In the event of a deficiency the Resolution provides that such deficiency shall be satisfied and made up by the County from any lawfully available money received in or attributable to fiscal year 1994-95.²⁰⁰

- b. *Official Statement, Dated September 26, 1994 \$320,040,000 Taxable Pension Obligation Bonds, Series 1994 A (\$209,840,000) and Series 1994 B (\$110,200,000), Series A Were Rated AA- and A1 by Standard and Poors and Moody's, Respectively. Series B Were Rated AA-/A1+ and A1/VMIGI, Respectively.*

1. Terms of Bonds

The Taxable Pension Obligation Bonds were issued to secure Orange County's obligation in the amount of \$318 million to the Orange County Employees Retirement System.²⁰¹ The bonds were a hybrid municipal security.²⁰² The County's obligation to repay the debt was absolute and unconditional and the payment was not limited to any specific source of revenues.²⁰³ But, they are not backed by the taxing power of Orange County. Thus, they were modified general obligation bonds or a variation of the moral obligation bond.²⁰⁴

The series A Bonds were interest rate swaps.²⁰⁵ Orange County agreed with the swap provider that the County would pay to the swap provider on each interest payment date, a variable amount based on the market rate, while receiving a fixed amount from the swap provider.²⁰⁶ The series B bonds were variable rate bonds with "put" rights for bondholders when the interest rate is reset pursuant to the terms of the securities.²⁰⁷ The series B bonds were also subject to optional and mandatory redemptions.²⁰⁸ Part of the security for the redemption

²⁰⁰*Id.* at 11.

²⁰¹September Official Statement, *supra* note 138, at i.

²⁰²*Id.* at 3-4.

²⁰³*Id.* at i.

²⁰⁴A moral obligation bond is one where the government issuer, although not legally bound to pay the bond, agrees to appropriate sufficient funds to make up any deficiencies in the monies available to pay principal and interest. DANIEL MANDELKER ET AL., *STATE AND LOCAL GOVERNMENT IN A FEDERAL SYSTEM* 321 (3d ed. 1990).

²⁰⁵September Official Statement, *supra* note 138, at 3.

²⁰⁶*Id.*

²⁰⁷*Id.* at 5-6.

²⁰⁸*Id.* at 10-11.

payments on the series B bonds was the County's portion of the Investment Pool.²⁰⁹

2. Participants

The managing underwriters were CS First Boston; Kidder, Peabody & Co. and Donaldson, Lufkin & Jenrette.²¹⁰ The underwriters' counsel was a California firm who had, on other occasions, represented Orange County.²¹¹ Bond counsel had also represented the underwriters in other unrelated transactions. These relationships were disclosed in the official statement. Also, participating in the offering was O'Brien Partners, Inc., as financial advisor.²¹²

3. Disclosure

The September Statement, like the July Statement, contained a section on the Investment Pool, entitled "The Orange County Treasurer's Investment Pool" (a prescient title).²¹³ Oddly enough, the September Statement did not track the earlier July Statement, as one might have expected given the short time period between these offerings. The description of the Investment Pool in the September Statement started out with a general sentence to the effect that the County's "investment policy focuses on retaining the safety of investment principal while earning satisfactory yields."²¹⁴ It went on to provide:

The Treasurer provides investment services for approximately 180 separate local government agencies through the operation and management of the [Orange] County Pool. Each of these agencies has different and separate cash flows and cash requirements. All of these agencies require funds to be available upon demand. The [Orange] County Pool's investment portfolio therefore consists largely of short term securities.²¹⁵

²⁰⁹September Official Statement, *supra* note 138, at 16-18.

²¹⁰*Id.* at cover page.

²¹¹*Id.* The firm was Jones, Day, Reavis & Pogue of Irvine, California.

²¹²*Id.*

²¹³September Official Statement, *supra* note 138, at 19.

²¹⁴*Id.*

²¹⁵*Id.*

However, unlike the July Statement, the September Statement did not mention marketability, volatility, or the amount of investments in derivatives. In the July offering, the balance of the Investment Pool as of June 16, 1994, was stated to be \$7.71 billion based on original cost.²¹⁶ There was no comparable statement in the September Statement. In a section entitled "Investment Performance," the September Statement put the net yield on invested funds for the FY 1993-94 at 7.67%.²¹⁷ It did not refer to previous years performances, as did the July Statement. The section on "Risk Factors" was silent as to the Investment Pool and the possibility of losses on investments.

Looking at these two official statements, one has to ask who wrote them, and perhaps more importantly, who read them? These discrepancies point to a conclusion that Orange County sought to brighten its disclosure document in the September offering by deleting negative information.

As further evidence of this, one need only compare the descriptions contained in the statements about Orange County. The description of the issuer is standard fare for public offerings by state and local governments. Typically, included in this part are statements about the size and wealth of the issuer, major industries and employers, and trends with respect to revenue sources of the County. With a frequent issuer, this section is usually boilerplate language, updated to reflect current information. Therefore, one would not expect to see many differences between an official statement issued in July 1994 and one issued in September 1994.

However, there are significant differences between these statements. Appendix A is a chart which compares the provisions of the July Statement concerning the general description of Orange County, with those of the September Statement. As can be seen in this comparison, the significant changes made in the September Statement were uniform in that the later official statement consistently deleted information, rather than adding new information. Information which was negative was minimized or eliminated.

PART THREE — ANALYSIS

A. *Disclosure Incentives*

The scheme for the existing system of regulations of the municipal securities market is to provide a mechanism to force municipal issuers to

²¹⁶July Official Statement, *supra* note 184, at 9.

²¹⁷September Official Statement, *supra* note 138, at 20.

disclose information by tying issuer disclosure to access to the market for public offerings. Relying to a great extent on the theory that once information is public, the security prices will accurately reflect such information, Rule 15c2-12, in particular, places more emphasis on giving the information to the underwriters and on decentralized filings than on getting information into the hands of the public investors or to the regulatory authorities.²¹⁸

There is no mechanism, other than the threat of litigation either by the SEC or private parties for violations of Rule 10b-5, to ensure that the disclosure in official statements is adequate or timely. The lack of litigation mechanisms may be interpreted as a sign that disclosure regulation for the primary market is not needed in the sense that nondisclosure does not result in investor losses. Given the trends in the municipal securities market, particularly with respect to the nature of the investor and the complexity of the securities, it is difficult to believe investors in the municipal securities market are, as a group, in less need of the disclosure protection than investors in the corporate market. Seventy-six percent of the municipal securities are held by individuals either as individual investors or through mutual and money market funds.²¹⁹

Moreover, as I have written elsewhere, there are important efficiency reasons to require disclosure in the primary market.²²⁰ Studies of organizations, generally, and governments, specifically, suggest that negative economic information will not be disclosed willingly; if negative economic information is disclosed at all, the disclosure will not be timely.²²¹ In Orange County, approximately 800 holders of obligations were not paid on time.²²² The County's operating budget was slashed 41%.²²³ Approximately 1600 County employees lost their jobs, half from the County's social services agencies.²²⁴ Under a new plan worked out with the State, \$15 million will be set aside over approximately twenty years to pay off the County's creditors. These are funds that would otherwise go to public transportation, and other public services.²²⁵

²¹⁸See *supra* notes 31-53 and accompanying text.

²¹⁹Levitt, *supra* note 135, at 7. Mutual funds hold 15% of outstanding municipal securities. PUBLIC SECURITIES ASSOCIATION, DEBT MARKET REPORT (annual report for 1994).

²²⁰See Gellis, *supra* note 9, at 21-25.

²²¹*Id.* at 44-56.

²²²Utley, *Creditors Approve One-Year Rollover*, *supra* note 179, at 7.

²²³Leslie Wayne, *Orange County Financial Plan is Devised*, N.Y. TIMES, July 19, 1995, at A10.

²²⁴Sterngold, *supra* note 135, at D8.

²²⁵Michael Utley, *County, Merrill to Argue Lawsuit's Merit in Court Today*, THE BOND

Despite the gains made in the last twenty years in disclosure practices, there is still a problem of inadequate disclosure in the municipal securities industry. The Orange County bankruptcy shows the limitations of the current system in fostering disclosure in the primary and secondary markets.

1. Disclosure By Issuers

Mr. Citron had fought a successful re-election campaign in June, 1994, with Merrill Lynch's financial support. One of the major issues in the election was the incumbent's high risk investment policies and the pitfalls of such policies.²²⁶ As a result of charges made by Citron's opponent published in a *Wall Street Journal* article in May 1994, SEC officials from the Los Angeles office had separate meetings with the challenger Mr. Moorlach and with Mr. Citron and his staff. Nothing came of the meetings. In later testimony before a House Banking Subcommittee looking into municipal securities disclosure in July 1995, Paul Maco, director of the SEC's Office of Municipal Securities, testified that there had been no indication of fraud, and therefore, nothing the SEC could or should have done at the time.²²⁷

The degree of riskiness in a local government's investment fund was a matter for the state government to consider, not the SEC. If, however, there had been prior staff review of the County's official statements subsequent to May 1994, it is likely that the lack of disclosure concerning the investment policies and existing losses would have been noticed. At the same congressional hearing, representatives of the two major ratings agencies, Standard & Poors and Moody's, were asked to explain the high ratings given Orange County securities. They testified that they had also relied on information supplied by the County, or more specifically, Mr. Citron.²²⁸

The reluctance or failure to look further, to ask for more information, or to ask hard questions is part of a culture of nondisclosure in the municipal securities market. It highlights the structural weakness of the current system of regulation. Since the Tower Amendment prohibits review of disclosure documents prior to the issuance of

BUYER, Dec. 1, 1995, at 48.

²²⁶Earl C. Gottschalk, Jr., *Derivatives Roil California Political Race*, WALL ST. J., Apr. 15, 1994, at C1.

²²⁷*The Municipal Securities Markets: Hearings Before the Comm. on Banking and Financial Services*, 104th Cong., 2d Sess. (July 26, 1995), 1995 WL 441680 (SEC), at *5-7 (1995).

²²⁸Wayne, *supra* note 139, at D4.

securities, there is no regulatory means to take proscriptive action. The *ex post* remedy of civil actions based on the antifraud provisions of Rule 10b-5 is inadequate.

There is little reason to believe that the number of suits litigated against issuers by either the SEC or by investors will be of sufficient number to impress upon issuers the consequences of nondisclosure. Neither the New York City nor the WPPSS investigations resulted in actions for fraud against the issuers by the SEC, despite lengthy reports which would have supported an action. Bondholders did sue. In the case of New York, the court held that section 10(b)-5 did not cover municipalities.²²⁹ In the WPPSS litigation, there were settlements aggregating nearly \$700 million.²³⁰ Settling defendants were mainly underwriters.²³¹ There were no Rule 10b-5 actions brought by the SEC against municipalities as issuers in the years 1989-1994.²³² Finally, the SEC's investigation of the Orange County fiasco was settled without any monetary fines.²³³

²²⁹*In re New York City Mun. Sec. Litig.*, 507 F. Supp. 169, 180-81 (S.D.N.Y. 1980).

²³⁰Robert W. Collin, *What the Law Says About Orange County: Creditors' Rights and Remedies on Municipal Default*, 16 MUN. FIN. J. 52, 57 (Summer 1995).

²³¹*Id.*

²³²See 1993 SEC STAFF REPORT, *supra* note 9, app. D, at 1-16 for SEC cases involving municipal securities in the 10-year period 1983-1993; *see also* 1990-1994 SEC. ANN. REP. (discussing major litigation involving the SEC). Most of the SEC enforcement actions are, as would be expected, against brokers and dealers. Even there, for the 10 year period (1983-1993), municipal securities cases related to disclosure were comparatively few. A *Bond Buyer* survey of court documents finds only three cases brought by the SEC against municipal issuers for misleading disclosures. Lynn Stevens Hume, *Denver's Position on Securities Fraud Law Shocks Some Market Observers*, THE BOND BUYER, Dec. 13, 1995, at 1, 7.

In addition to Orange County, the SEC is currently considering actions based on violations of the antifraud provisions of the Exchange Act against Nevada County, California (involving a defaulted issue of non-rated bonds). Michael Utley, *California County Argues Against SEC Fraud Charges*, THE BOND BUYER, Dec. 7, 1995, at 1, 3. It is also investigating Denver's disclosures on bonds issued to finance its new airport. Lynn Stevens Hume, *SEC Faces Mounting Debate Over its Enforcement Cases*, THE BOND BUYER, Dec. 18, 1995, at 1, 32. The response of issuers to these investigations is telling in that, despite 20 years of regulation, issuers are amazed to find out they are subject to Rule 10b-5. The city of Denver is, in fact, asserting that municipal issuers are not subject to Rule 10b-5. It seems clear, however, that, unless regulation of the municipal securities market is a violation of the Tenth Amendment, Denver's position is incorrect.

²³³The defendants, Orange County Flood Control District and Orange County Board of Supervisors and its officers, settled without admitting or denying the allegations, whereby the SEC got a civil injunction and a cease and desist order. *SEC Enforcement: SEC Announces Actions Relating to Orange County Investigations*, SEC. REG. & L. REP. (BNA) No. 4, at 103 (Jan. 26, 1996).

But, even if the SEC were to vigorously enforce the antifraud provisions, as it has begun to do, municipal defaults and crises have an impact far wider than the creditors' pocketbooks. New York, WPPSS, and Orange County crises each resulted in market-wide dislocations.²³⁴ In the cases of New York and Orange County, as general function local governments with a range of public services relied on by the public, their financial woes extended to its citizens and to employees. A Rule 10b-5 suit cannot correct these municipal securities market disasters.

2. Disclosure by Financial Professionals

What can be said of the performance by underwriters, financial advisors, underwriters' counsel, and bond counsel involved in the Orange County offerings? These people worked on the County's official statements on more than one transaction. At a state hearing, a representative of the bond counsel for Orange County admitted that she knew in October that the Investment Pool had suffered substantial losses. Asked why those losses had not been disclosed, as would now be required under the amended Rule 15c2-12, she responded that "disclosure wasn't her responsibility."²³⁵ Unfortunately, this has been a long held belief of bond counsel, a part of the culture of nondisclosure.

The role of bond counsel was sharply criticized in both the Staff Report on the Transactions in the Securities of the City of New York and in the Staff Report on the Transactions in the Securities of WPPSS.²³⁶ In each case, bond counsel failed to investigate and make material disclosures concerning negative information. Even today, the National Association of Bond Lawyers is one of a very few industry groups who have not endorsed the principle of periodic disclosure²³⁷ and have come

²³⁴See Gellis, *supra* note 9, at 29, for a discussion of the market effects in connection with the two earlier crises. Nearly 10 years later, WPPSS bonds still show a negative price effect, trading cheaper than other comparable double AA-rated bonds. Jon Birger, *WPPSS Bonds May be a Bargain But Their '80s Stigma Still Lingers*, THE BOND BUYER, Dec. 7, 1995, at 1, 8.

²³⁵Michael Utley, *Officials Say Many Saw Crisis Coming But None Spoke Out*, THE BOND BUYER, Feb. 21, 1995, at 1, 9.

²³⁶NEW YORK SEC REPORT, *supra* note 2, at 81; WPPSS SEC REPORT, *supra* note 2, at 26.

²³⁷See, e.g., Lynn Stevens Hume, *NABL's Next Chief is "Glad" G-37 Decision is Appealed*, THE BOND BUYER, Sept. 20, 1995, at 1, 27. In questioning the need for MSRB Rule G-37 with respect to financial consultants, the now head of the organization is quoted as saying, "[T]he information is out there if people want to find it." *Id.* This article also points out that most NABL members have not adopted a policy of disclosure of political contributions by law firms. *Id.*

under criticism for its general attitude of nondisclosure. At present, the group is resisting efforts of some bar associations to require disclosure of consultants used by lawyers and to restrict campaign contributions.

Insofar as the underwriters are concerned, it seems clear that despite two lengthy SEC interpretive releases focusing on underwriters' responsibilities,²³⁸ underwriters' due diligence has not taken hold. There is little incentive for the underwriters to do much more than a cursory review. The default rate for municipal securities traditionally has been low, and there is limited trading.²³⁹ These factors taken together have made for a system characterized by little litigation. Thus, for the underwriter, the risk of being sued is less than any benefits to be derived from less due diligence and from pleasing its client, the issuer.²⁴⁰

There is also the problem of musical chairs with respect to a frequent issuer. Bond counsel and underwriters' counsel often exchange roles from one offering to the next. The same is true of underwriters and financial advisors, as demonstrated by Orange County's offerings.²⁴¹ Although this is neither corrupt nor illegal, it does accentuate the cozy relationships of the parties, which decreases the likelihood that a thorough investigation will be made.²⁴²

²³⁸Municipal Securities Disclosure, Exchange Act Release No. 26,100, 53 Fed. Reg. 37,778, 37,787-37,791 (Sept. 28, 1988); Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Release No. 33,741, 59 Fed. Reg. 12,748 (Mar. 17, 1994).

²³⁹Much is often made of the low default rate for municipal bonds as compared with corporate bonds. In the period 1983-1988, the rate of default on municipal bonds was 0.7%, while the default rate for corporate debt was only slightly higher than 1.1%. Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 699 (1995). More recent figures see both rates increase, with a larger increase for corporate bonds. See *infra* note 261.

²⁴⁰See Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1029 (1984) (discussing that shelf registration will ultimately result in less due diligence).

²⁴¹Each of the two official statements examined disclosed multiple roles for Orange County's advisors and counsel. In the July Statement, for example, counsel to the financial consultant, Leifer Capital, Inc., was Brown & Wood, who, in turn, is one of Merrill Lynch's outside counsel. Merrill Lynch was the investment bank through whom Orange County did much of its investment. The September Statement discloses that bond counsel had represented the underwriters on matters unrelated to the bonds and that counsel to the underwriter had represented the County and the Orange County Employees Retirement System on matters unrelated to the bonds. Compare July Official Statement, *supra* note 184 with September Official Statement, *supra* note 138.

²⁴²Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 104th Cong., 2d Sess. (1995), 1995 WL 361825, at 8-13 (SEC) (testimony of Arthur Levitt, Jr., chairman of the Securities and Exchange Commission).

Trying to achieve a more effective system for municipal disclosure requires repeal of the Tower Amendment. As long as the Tower Amendment remains the law, one is confined to a system that is, by and large, procedural, with little concern *ex ante* for content. Even with these confines, however, there are problems with the current system of regulation which limit its effectiveness.

B. *Too Many Cooks*

In comparing the municipal securities market to that of the corporate market, the most noticeable and significant aspect of the municipal securities market is that of numbers: there are 50,000 municipal issuers, with \$1.2 trillion aggregate principal in securities outstanding.²⁴³ An average of 8,000 municipal issuers go to market each year.²⁴⁴

Any observation of American politics at the local level points out the large number of local governments with either praise of the decentralized, community controlled political system, or with criticism of the inefficiency and balkanization resulting from local government control. In fact, the sheer size of the number of potential issuers is usually the first reason given (other than the Tower Amendment) for not adopting the system of securities regulation that exists for corporate issuers.

The system of regulation that is now in place shares this basic characteristic of too many players and too many regulators. Unlike the corporate securities market, which has one federal regulatory agency, the SEC, the municipal securities market has two, the MSRB and the SEC. As an entity, the MSRB is more like the SEC than it is like the other SROs. The staff of the MSRB often make pronouncements as to actions it or the SEC will take. The two regulate on the same concerns, with the baton of leadership on any particular issue switching back and forth between the two.²⁴⁵

²⁴³1993 SEC STAFF REPORT, *supra* note 9, at 1.

²⁴⁴Levitt, *supra* note 135, at 7 n.3.

²⁴⁵For example, regulation of periodic disclosure originally was to be under the MSRB's umbrella, but problems with the Tower Amendment caused the shift to the SEC. See *infra* note 252. MSRB rules with regard to ratings disclosure, T-3 settlement, and price transparency were each initiated with the prodding of the SEC. In an SEC release issued on November 17, 1994, addressing ratings disclosure, the release states that the "portion of Rule 15c2-13 that would require disclosure if a municipal security was not rated by an NRSRO [nationally recognized statistical rating organization] has been deferred and will be withdrawn if the MSRB acts to adopt similar amendments to its confirmation rule, Rule G-15."

Enforcement of MSRB rules is not by the MSRB but given to a total of five different entities: the NASD, the SEC, and the three federal regulators of banks.²⁴⁶ Since the number of banks acting as municipal securities dealers has been declining in recent years, having three separate regulators underscores the inefficiency of this enforcement mechanism. The statutory make-up of the Board also reflects the much greater role that banks played in the market at the time the MSRB was created in 1975.²⁴⁷ The bank's dealers have five members, issuers have a minimum of one and a maximum of four.²⁴⁸

There is also the ineffectiveness of the filing requirements. Where disclosure documents are filed depends on what kind of document is being filed. Under Rule 15c2-12, official statements may be filed with a NRMSIR (not necessarily all), and a copy must accompany the confirmation of a sale to a customer who requests one.²⁴⁹ The Rule itself does not require a copy to be filed with the MSRB or the SEC. Under MSRB Rule G-36, however, two copies of the official statement are to be filed with the MSRB,²⁵⁰ one of which is then filed in the Municipal Securities Information Library, a central file available for public use. Annual financial information required by paragraph (b)(5) of Rule 15c2-12, on the other hand, is to be filed with *each* NRMSIR and any relevant SID; whereas the material event statements can be filed either with each NRMSIR or the MSRB and any SID.²⁵¹

It is hard to understand why a number of filings are required for some secondary market disclosures, but not for others. The omission of any filing requirements with the SEC may be for the purpose of minimizing the argument that the Rule violates the Tower Amendment, even though no filings are subject to prior review.²⁵² Added to this

Confirmation of Transactions, Exchange Act Release No. 34,962, 59 Fed. Reg. 59,612, at 59,613 (Nov. 17, 1994). The MSRB did amend its rule. Similarly, changes in the MSRB's suitability rules (Rule G-19) were enacted at the specific suggestion of the SEC set forth in a letter from the Director of the Division of Market Regulation. Letter from William H. Heyman to Christopher Taylor, Executive Director (May 8, 1992).

²⁴⁶See 1993 SEC STAFF REPORT, *supra* note 9, at 17, 53-54, in which the staff discusses the split of enforcement. It expresses support of the existing structure but laments the lack of cooperation and coordination among the regulators. *Id.*

²⁴⁷15 U.S.C. § 78o-4(b)(1) (1994).

²⁴⁸*Id.*

²⁴⁹17 C.F.R. § 240.15c2-12(b)(4) (1995).

²⁵⁰MSRB MANUAL, *supra* note 19, ¶ 3676 (Rule G-36(b)(i)).

²⁵¹17 C.F.R. § 240.15c2-12(b)(5)(i)(A), (C) (1995).

²⁵²By its terms, § 15B of the 1934 Act prohibits the SEC from requiring issuers to make *prior* filings. The MSRB, on the other hand, is prohibited from requiring issuers to file any documents or information with the MSRB or to provide any document or information to

layered structure is the fact that there is little direction, particularly with respect to the continuing disclosure rules, as to what is to be filed, other than the basic rule that whatever was filed in the official statement must be updated and continued.²⁵³ Even accepting the fact that the electronic age makes filing in a number of places much easier, and that information is more easily stored and accessed, this system is overly convoluted.

C. Enforcement; Effectiveness

In the end, we have a securities market with many issuers and issues, where issuers are required to produce information unspecified as to content or form, and to disseminate this information to a sizeable number of different entities depending on the nature of the filing. But, no filing of an official statement, annual report, or material events statement, all required by Rule 15c2-12, is made with the SEC. This ought to make SEC oversight difficult. Similarly, underwriters, with whom the issuers contract under amended Rule 15c2-12, have no duty beyond the investigations necessary under the MSRB suitability rules to see that issuers live up to their contractual promises.

Rule 15c2-12 is not completely without teeth. Dealers are required to put in place procedures for obtaining current information and notices of material events so their recommendations will be made with complete disclosure.²⁵⁴ Issuers are to notify each NRMSIR or the MSRB of any failure of an obligated person to provide annual financial information as required by its agreements.²⁵⁵ The Rule also requires the official statement of an issuer to contain a statement of any failures within the prior five years by it or by other obligated persons to abide by their agreements related to other offerings.²⁵⁶

a purchaser. The SEC is specifically not subject to this much broader prohibition. 17 C.F.R. § 15B(d)(2) (1991).

²⁵³17 C.F.R. § 15c2-12(b)(5)(i)(A); Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Release No. 33,741, 59 Fed. Reg. 12,748 (Mar. 17, 1994). For example, if audited financials are used in the official statement, all future financials must be audited. The proposed Rule 15c2-12(b)(5) would have required municipal issuers to use audited financials. This was removed in the face of much criticism to the effect that municipal issuers are too diverse; for some, using audited financials would be a prohibitive cost. Municipal Securities Disclosure, Exchange Act Release No. 34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,456, at 85,954-85,958 (Nov. 10, 1994).

²⁵⁴17 C.F.R. § 240.15c2-12(e) (1995).

²⁵⁵17 C.F.R. § 240.15c2-12(b)(5)(i)(D) (1995).

²⁵⁶17 C.F.R. § 240.15c2-12(f)(3) (1995).

Most recently, the SEC has announced that it does not intend to increase its *own* enforcement of Rule 15c2-12. The SEC sees the Rule as a procedural rule to be enforced primarily by the NASD. Yet, the SEC's recent condemnation of the NASD for failure to police the municipal securities market and enforce Rule G-37 is evidence of the inefficiency of this approach to enforcement.²⁵⁷ Ultimately, Rule 15c2-12 relies on market forces to bring compliance. The difficulty is that markets can only do so much to control government behavior. One need only to look at the fate of Orange County's proposed increase in the sales tax for evidence of this fact. One would expect Orange County citizens to prefer the County to externalize the costs of their financial mistakes to the County's creditors rather than levy a tax to pay their debts. That is exactly what they chose to do. Recent news articles point out that the poor and disadvantaged are bearing the brunt of the County's budget cuts. The middle class and wealthy have been largely untouched.²⁵⁸

There are few cases in this area because in the past municipal issuers rarely defaulted or filed for bankruptcy protection.²⁵⁹ The "full faith and credit" guaranty of general obligation bonds has depended largely on the issuer's good faith, and the long memory of the market. However, full faith and credit means less today, given the enactment of property tax limits that restrict raising funds even to pay the government's debt obligations. Orange County is the first, although probably not the last large government issuer, to use Chapter 9 of the Bankruptcy Act to avoid its debt obligations. The rare default and the code of ethics not to default on guaranteed debt were a part of a time of prosperity which no longer exists.

Defaults under "conduit" bonds, bonds where the municipal issuer is not the economic borrower, are the most common. Such bonds are issued to give the economic borrower the benefit of the issuer's federal interest tax exemption. Payments on the bonds are either from revenues of the conduit or from project revenues.²⁶⁰ Similarly, defaults are higher

²⁵⁷Hume, *SEC Slams NASD*, *supra* note 114, at 7; Michael Stanton, *Maco Says SEC Doesn't Plan Special 15c2-12 Enforcement*, THE BOND BUYER, Dec. 14, 1995, at 1.

²⁵⁸Sterngold, *supra* note 135, at D8.

²⁵⁹The City of Bridgeport, Connecticut, filed for bankruptcy in 1991; but with the State's opposition and a new election, the proceedings were truncated. The State objected to the filing on a number of grounds. The bankruptcy court agreed with the State that on the date of filing, Bridgeport was neither insolvent nor on the brink of insolvency. There was no appeal because of a change in city administration. James Spiotto, *Municipal Insolvency: Bankruptcy, Receivership Workouts and Alternative Remedies* in 3 M. DAVID GELFAND, STATE AND LOCAL GOVERNMENT DEBT FINANCING, ch. 13, § 13.38 (1994).

²⁶⁰See 1993 SEC STAFF REPORT, *supra* note 9, at 1 (defining revenue bonds and

for unrated, uninsured bonds.²⁶¹ The SEC has proposed legislation to Congress making conduit financing subject to the same registration requirements as corporate securities.²⁶² Should this ever come to pass, disclosure problems with those securities would be addressed. The MSRB, at the SEC's urging, has amended its rules to require customer's confirmation statements to disclose when a bond is unrated.²⁶³

As far as the small, unrated issues are concerned, Rule 15c2-12 does not apply to offerings of less than \$1 million.²⁶⁴ Thus, the new changes will not affect disclosure for these offerings. Issuers with outstanding securities (including the present offering and any other securities of the issuer previously exempted because of the small size of the issue) which do not aggregate to more than \$10 million are exempt from the requirements related to filing annual financial information, but not from the requirement of filing notices of "material events."²⁶⁵ As a consequence, the types of issuers more likely to default are probably under no duty to provide information; and while there is an obligation on small issuers to give notice of "material events," there is no mechanism to insure compliance by these small issuers.

Defaults in the municipal securities market fall at the two ends of a continuum. At one end are the small bond issues as discussed above. At the other end are the large defaults that shake the market and have widespread effects on the local economy. Orange County was in the second group. Evidence, both in terms of the disclosure inadequacies in its official statements and in terms of timeliness, reminds us that

conduit bonds).

²⁶¹In the 1993 SEC Staff Report, the staff cites to a report by one of the leading municipal bond financial institutions, *Municipal Bond Defaults — The 80's: A Decade in Review* (2) (J.J. Kenny Co. 1993), which found that "the incidence of default among all the bonds in the study appeared to be inversely related to the 'essentiality' of the bond-finance projects." 1993 SEC STAFF REPORT, *supra* note 9, app. B, at 3. The problem of defaults by small issuers and small issues in general regarding the application of the securities laws is not unique to the municipal securities market but has parallels in the corporate market. *See, e.g.*, Confirmation of Transactions, Exchange Act Release No. 34,962, 59 Fed. Reg. 59,612 (Nov. 17, 1994) (requiring disclosure of non-rated corporate bonds in confirmations); *see generally* J. WILLIAM HICKS, LIMITED OFFERING EXEMPTIONS: REGULATION D, § 1.03 (1995-96) (providing an overview of the rules governing small issues); 3 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1307-19 (3d ed. 1989) (discussing the efforts of Congress and the SEC to find the right level of regulation of small issue offerings which protects the investor with respect to higher risk securities and which is not prohibitively costly).

²⁶²*See* Confirmation of Transactions, Exchange Act Release No. 34,962, 59 Fed. Reg. 59,612 (Nov. 17, 1994).

²⁶³*See* MSRB MANUAL, *supra* note 19, ¶ 3571 (Rule G-15(a)(i)(C)(3)(f)).

²⁶⁴17 C.F.R. § 240.15c2-12(a) (1995).

²⁶⁵17 C.F.R. § 240.15c2-12(d)(2), (d)(2)(ii)(B) (1995).

politicians will cover up negative economic news for as long as they can.²⁶⁶ If Orange County's disclosure is any measure of underwriters due diligence or rating agencies' information, these groups are not providing the necessary monitoring functions.

The issue of timeliness of disclosure has been recognized by most observers and participants in the municipal securities market as a continuing problem, even with disclosure in primary offerings.²⁶⁷ Given the decentralized system for disseminating information and the lack of parallelism between the rulemaker and rule enforcer, it does not seem likely that the new requirements will lessen the problem of timeliness.

D. *Consequences of Rule G-37*

There is no way of documenting whether the marketplace is more corrupt today than in the past, although observers of the market seem to believe that the "pay-to-play" practices have become more prevalent.²⁶⁸ It may well be, however, that rather than the market being more corrupt and inequitable, the increased federal regulation of market disclosure has caused old "pay-to-play" practices to stand out more sharply and be more at odds with the underlying premise of federal securities laws to provide for a fair and open market. There may seem to be more instances of kickbacks, bribes, etc., simply because the SEC and the MSRB have focused their attention on the subject.

In fact, the first stirrings to do something about corruption came from the dealers themselves through the MSRB. Without diminishing the benefits of a rule like Rule G-37, the rule is, of course, self-serving for dealers. Now, dealers do not have to spend money to contribute to public officials' campaigns, knowing that all dealers are so prohibited.

Finally, the existence of more corruption may also be a result of an increase in complex financings. The difference in the level of

²⁶⁶See Gellis, *supra* note 9, at 44-65, for an analysis of incentives and motivations of politicians and bureaucrats not to disclose negative economic information. Empirical evidence from New York City, WPPSS, and Orange County documents the theoretical analysis of bureaucratic behavior.

²⁶⁷*Id.* at 67-68. See also Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Release No. 33,741, 59 Fed. Reg. 12,748 (Mar. 17, 1994) (discussing problems with compliance and the need for reform regarding disclosure in the municipal securities market). Standard & Poors has recently indicated that it will pull the bond ratings of issuers who fail to provide annual financial information as required under Rule 15c2-12(b)(5)(i). Lynn Stevens Hume, *S&P May Pull Bond Ratings if Disclosure Rules Not Met*, THE BOND BUYER, Nov. 28, 1995, at 1, 4.

²⁶⁸Hume, *Pay-to-Play*, *supra* note 125, at 3.

sophistication and variety of securities now used in the municipal securities market as compared to the financings of just fifteen years ago is vast. Municipal issuers now issue securities that go beyond the bread and butter general obligation and revenue bonds of the past. They market derivative securities, variable rate securities, collateralized securities, and even taxable securities. Given the resource limitations of state and local governments, coupled with a continuing need to borrow, issuers are more dependent on outside financial advisors than ever before, both formal and informal.

Will the new Rule G-37 help eliminate corruption? The history of "good government" reforms at the local level, such as competitive bidding, has been of mixed results. For example, the growth of quasi-municipal entities in the post World War II era to provide public services was, in part, motivated by a desire to avoid the earlier "good government" reforms, such as civil service and competitive bidding in the purchase of goods and services, which reforms were later perceived as bureaucratic red tape. In a similar fashion, commentators now point to the myriad of special districts and authorities as adding to the balkanization of local government and a lack of accountability to the citizenry.

The fact that the "pay-to-play" custom has dominated the process of underwriting municipal securities is not very surprising. Politics and corruption are natural handmaidens. In fact, the traditional state laws requiring municipal issuers to use competitive bidding were enacted precisely to prevent corruption and favoritism in the award of underwriting contracts.²⁶⁹

The adoption of Rule G-37, which is applicable only to negotiated underwritings, should result in more competitive bid offerings. This was no doubt one of the intended results of Rule G-37. The chairman of the SEC has spoken in favor of greater use of competitive bidding because it is less costly, and there is less opportunity for influence peddling.²⁷⁰

²⁶⁹See Peter W. Salsich, Jr., *State Laws Regarding Issuance of Bonds and Notes* in 3 GELFAND, *supra* note 259, ch. 11, § 11:27; see also *City of Miami v. Benson*, 63 So. 2d 916 (Fla. 1953) (holding that a contract binding the city to sell its bonds to its agent, advisor, and employee is contrary to public policy and the proposal by the same agent, advisor, and employee to buy such bonds and the acceptance by the city commission to deal were also contrary to public policy). The Florida Supreme Court held that a negotiated underwriting agreement with First Boston was void as against public policy, even though the applicable state statute permitted negotiated sales, because the underwriter has an inherent conflict of interest as agent of the issuer and purchaser of the bonds. *Id.* at 920-21.

²⁷⁰1993 *Congressional Hearings*, *supra* note 60, at 6, 210 (testimony of Arthur Levitt, Jr.).

Thus far, the numbers do not show any sustained, significant increase in its use.²⁷¹

The advantages and disadvantages of both competitive bidding and negotiated underwritings are one of the few areas of the municipal securities market which have been studied by finance scholars. Various studies show that, if bringing securities successfully to market at the lowest costs to the issuer is the goal, then a municipal securities issuer must be able to use both forms of underwriting.²⁷² For plain vanilla general obligation bonds and revenue bond financings, competitive bidding is usually cheaper.²⁷³ However, as a financing grows in dollar volume and complexity, it becomes more cost efficient to use a negotiated underwriting.²⁷⁴ Another factor which is critical to the decision of which form to use is the potential number of bidders. Evidence consistently shows that the fewer the bidders, the more likely no cost savings will be obtained from using competitive bidding.²⁷⁵

New Jersey law provides a good example of a state's predicament in trying to eliminate opportunities for influence peddling and kickbacks by eliminating negotiated offerings. One of the SEC's first widely publicized enforcement actions related to political corruption involved a New Jersey issuer's negotiated offering. Political officials and other businesses received various undisclosed payments for helping to secure the issuer's business. In response to the investigation, Governor Thomas Florio issued an order prohibiting negotiated offerings except under "extraordinary circumstances" and only if approved by the state treasurer.²⁷⁶ The effect was to stall large and complex municipal securities offerings.²⁷⁷ Two years later, in 1994, Governor Christine Todd Whitman revised the order to allow negotiated offerings where the complexity or size makes a negotiated offering more suitable.²⁷⁸ The

²⁷¹In 1994, 30.1% (49.5 billion of 164.5 billion) of new issues were competitively bid. At year end in 1995, the percent was 26% (\$41.1 billion of \$158.86). PUBLIC SECURITIES ASSOCIATION, DEBT MARKET REPORT (annual report for 1994).

²⁷²See generally Paul A. Leonard, *Negotiated Versus Competitive Bond Sales: A Review of the Literature*, 15 MUN. FIN. J. 12 (Summer 1994) (providing a compilation and evaluation of the finance studies of the two underwriting processes).

²⁷³*Id.* at 14.

²⁷⁴*Id.* at 16.

²⁷⁵*Id.* at 32.

²⁷⁶Charles Gasparino, *New Jersey Considering Expanding When to Use Negotiated Bond Sales*, THE BOND BUYER, Aug. 5, 1994, at 1.

²⁷⁷Joyce Hanson, *New Jersey Gov.'s Order May Affect Transportation Issues*, THE BOND BUYER, Mar. 15, 1995, at 1, 28.

²⁷⁸Joyce Hanson, *New Jersey Agencies Prepare for More Negotiated Sales Due to Executive Order*, THE BOND BUYER, Dec. 29, 1994, at 2.

revision also dropped the requirement of obtaining the state treasurer's approval.²⁷⁹

Even more interesting than the SEC and MSRB's recognition of corruption is the question of what motivates the federal regulators to regulate local campaign contributions when the practices do not directly affect the interests of the investors in municipal securities? Chairman Levitt has suggested that pay-to-play practices make dealers less vigilant in their investigative duties.²⁸⁰ However, the connection between campaign contributions and investor concerns has been questioned by at least one court.²⁸¹

As discussed above, incentives for underwriters to perform due diligence are weak in the municipal securities market, even in connection with negotiated offerings where lack of time is not an acceptable excuse. Moreover, one of the drawbacks in using competitive bidding offerings, even where appropriate, is the smaller opportunity for underwriters to perform due diligence. Thus, to some extent Rule G-37 may help to get rid of corruption at the expense of disclosure.

Since Rule G-37 ought to result in more competitive bidding, there will be an increase in the use of financial advisors, which also affects disclosure. One unintended result of the original enactment of state statutes requiring competitive bidding for municipal securities offerings was the need for financial advisors. This function could not be provided by the managing underwriter as is standard in negotiated underwritings, because in competitively bid transactions, the underwriters are brought in at the end of the financing process.²⁸²

The splitting of the functions of underwriter into two separate providers, the financial advisor and the underwriter, has created a whole industry of financial consultants for municipal securities issuers. Some are investment bankers who also offer underwriting services (e.g., Merrill Lynch, Lazard Freres). Others are part of a growing number of firms specializing in financial advice only. The number of issues in which financial advisors participated increased 95% in the period 1986 to 1992.²⁸³ Use of financial advisors has become so prevalent that it is not

²⁷⁹*Id.*

²⁸⁰1993 Congressional Hearings, *supra* note 60, at 6, 210 (testimony of Arthur Levitt, Jr.).

²⁸¹*Blount v. SEC*, 61 F.3d 938 (D.C. Cir. 1995).

²⁸²See Robert A. Fippinger & Edward L. Pittman, *Disclosure Obligations of Underwriters of Municipal Securities*, 47 BUS. LAW. 127, 134 (1991).

²⁸³Craig L. Johnson, *The Changing Market Structure of the Municipal Financial Advisor Industry*, 15 MUN. FIN. J. 1 (Spring 1994) (discussing the expanding role of financial advisors). Evidence of the growth of a separate segment of professionals can be seen in the

unusual for an issuer to use a financial advisor in negotiated deals. The financial advisor essentially negotiates with the managing underwriter as to pricing, fees, etc. In 1992, financial advisors were used in 24% of the negotiated issues, both general obligation and revenue bonds.²⁸⁴ It appears that Orange County used a financial advisor in the two negotiated offerings discussed in Part II above.

The split in roles results in a confusion as to who is responsible for undertaking due diligence investigations and who may be liable as between the two parties. Both have overlapping responsibilities for disclosure. The advisor is an agent for the issuer, and typically controls the drafting of the official statement. As such, the financial advisor may have a primary responsibility for statements made in the official statement as opposed to the due diligence test for underwriters.²⁸⁵ At a minimum, they have no less an investigatory duty than underwriters.²⁸⁶

The use of financial advisors also introduces another opportunity for the use of other consultants, such as finders.²⁸⁷ Typically, the hiring of financial advisors is not subject to competitive bidding requirements, permitting public officials far more latitude in choosing an advisor and allowing the opportunity for political pay-offs. Thus, a shift to competitive bidding may be beneficial in terms of issuers' underwriting costs, but it may not eliminate the problems of conflict of interest and influence peddling. Nor does proposed Rule G-38, requiring disclosure of all consultants and their contracts, eliminate this problem for competitively bid offerings.

establishment in 1989 of a separate trade association for independent financial advisors). *Id.* at 2.

²⁸⁴*Id.* at 5. An earlier study of financial advisors looked specifically at the role of advisors in negotiated offerings. Ronald W. Forbes et al., *The Role of Financial Advisors in the Negotiated Sale of Tax Exempt Securities*, 8 J. OF APPLIED BUS. RES. 7 (1992). This earlier study found that the major function of advisors in negotiated transactions was to "certify" the underwriter's offering price with the result that the certification will lower the borrower's cost. *Id.* at 9-10. The study found that the costs of adding a financial advisor were "only moderately offset by corresponding benefits in the form of lower borrowing costs." *Id.* at 12. The authors cite other possible reasons for the use of financial advisors in negotiated underwritings: (1) to serve as a shield for the politician from the bond sale; (2) for "interpretative" services for a new issuer; (3) given the limits of monitoring the activity of local governments, evidence of the "opportunity for public officials to engage in more opportunistic behaviors." *Id.* at 12-13.

²⁸⁵See generally GELFAND, *supra* note 27, ch. 8A.

²⁸⁶Municipal Securities Disclosure, Exchange Act Release No. 26,100, 53 Fed. Reg. 37,778, 37,778 (Sept. 28, 1988) (SEC Interpretation of Underwriters Investigatory Responsibility); see *supra* text accompanying notes 282-83.

²⁸⁷See *supra* notes 115-25 and accompanying text (discussing MSRB Rule G-38).

CONCLUSION

Without repeal of the Tower Amendment, there are limitations on what can be accomplished to make the system more effective. In an earlier article, I advocated imposing registration requirements for public offerings of municipal securities, and imposing a civil liability scheme modeled after section 11 of the Securities Act of 1933.²⁸⁸ Admittedly, the prospects for enactment of registration requirements in an era of deregulation are slim. But, the second half of the proposal might be more palatable and, thus, of more practical utility. A statute that imposed liability on underwriters, financial advisors, and counsel for false and misleading statements contained in an official statement would, unlike the threat of liability under Rule 10b-5, impress upon these professional participants the importance of their due diligence obligations. Unless the professionals can demonstrate that they made a reasonable investigation, and after such investigation they had reasonable grounds to and did believe the statements to be true and not misleading, they would be liable for misleading or false statements. As is the case under section 11, the standard of care for financial professionals would be negligence, not intentional fraud or recklessness as is the case with Rule 10b-5 liability. This standard should create an incentive, missing from the current liability scheme, to pay closer attention to the content of disclosure documents. Professionals found to have been negligent would be held liable for the difference between the offering price and the value at the time of the suit or at the price at which the security was sold.

Unlike my earlier proposal, this modified scheme would not make issuers absolutely liable for misstatements in official statements. Rather, like financial professionals, issuers would be liable for negligent misrepresentations. The official statement is, of course, legally and practically the issuer's document. A scheme in which issuers could only be sued for intentional or reckless misrepresentations would be consistent with the existing scheme that focuses on changing the behavior of underwriters and counsel and would also allow for the continued protection of the issuer under the Tower Amendment. But, given the past experiences, it is doubtful that this (even with pressure from underwriters) would be sufficient to change issuer disclosure behavior.

Structurally, a less ambitious reform, one that also requires legislation, is to abolish the MSRB as a statutory entity. Since the SEC is actively regulating in the area, there seems little reason for two

²⁸⁸Gellis, *supra* note 10, at 108-21.

government regulators. The MSRB would then be on a par with the other SROs. It could decide its own make-up and could enforce its own rules (once approved by the SEC). SEC policies which apply to both markets (e.g., adoption of T+3 settlement; disclosure of unrated securities) could be handled with one action or rule, rather than separate lock-step rules, as is currently the case.

The effort to decentralize the dissemination of information should be reconsidered both in terms of issuer costs to file annual financial information and in terms of reducing the complexity of compliance. It would make more sense to have a central filing with the MSRB or the SEC and regional filings with one NRMSIR per region. As it is presently constituted, there are a possible seven filings for each issuer's annual financial information (six NRMSIRs + one SIDs). By simplifying the system, issuers would be less dependent on outside advisors and consultants and, hence, costs and opportunities for influence peddling would be lessened as well.

There is a strong impulse on the part of municipal securities market participants to make piece-meal changes in the regulation of the market in response to a crisis, and then to ignore the market and its operations until the next crisis. We are already entering this phase with respect to the recent events. The SEC, after all of its focus on the municipal securities market and the enactment of new regulation, has indicated that enforcement of Rule 15c2-12 will be left in the hands of the NASD. It announced that it does not plan to enforce its rule. It has entered into settlement of its enforcement action against Orange County and its officers, agreeing not to impose any monetary fines.²⁸⁹ The message is clear: as long as an issuer complies with the procedures, or is not caught by the NASD for noncompliance, no one is looking to the substance of disclosure. In other words, it's "business as usual" until the next Orange County, WPPSS, or New York City.

²⁸⁹SEC Enforcement, *supra* note 233, at 103.

APPENDIX A
THE COUNTY OF ORANGE
COMPARISON OF SELECTED SECTIONS
OF THE JULY AND SEPTEMBER
OFFICIAL STATEMENTS

JULY 1994**SEPTEMBER 1994****POPULATION****Growth During Last Decade**

- | | |
|---|--|
| <ul style="list-style-type: none">● Table statistics from 1983 to 1993● Presented a projected growth table | <ul style="list-style-type: none">● Table statistics from 1985 to 1994 |
|---|--|

INDUSTRY TRENDS & OUTLOOK

- | | |
|---|--|
| <ul style="list-style-type: none">● Total nonagricultural wage and salary employment (1,122,400) decrease of 2.9% (base of 1989)● Greatest decline in jobs was in manufacturing, retail trade, and construction● Period of slow growth in county has continued longer than expected and is anticipated to continue through 1994 | <ul style="list-style-type: none">● Total nonagricultural wage and salary employment (1,122,400) decrease of 1.9% (base of 1991)● Growth for all non-agricultural industries except mining and manufacturing
[No comparable statement re: growth] |
|---|--|

Construction

- | | |
|---|--|
| <ul style="list-style-type: none">● 47,400 jobs in 1992, down from 62,700 in 1989● Projected employment will not reach original forecast of 81,700 by 1996; now forecast | <ul style="list-style-type: none">● 47,400 jobs in 1992● Expected to increase 10.8% to 52,500 by 1998
[No comparable statement] |
|---|--|

52,500 (10.8% increase)
by 1998

- Industry has been among sectors hardest hit in current recession

Manufacturing

- Jobs declined by 32,600 from 1989-1992
- Original forecast of 276,900 jobs by 1998 too optimistic; now expect decrease of 5,500 jobs in durable goods and increase of 3,400 in nondurable goods
- Jobs declined by 25,600 from 1990-1992
- Total manufacturing employment expected to decline by 1% to 216,300 in 1998

Transportation & Public Utilities

- 1992 jobs average 35,300 an increase of 2.9% over 1989
- Figure should rise to 39,700 by 1996
- 1992 jobs average 35,300
- Figure should reach 37,800 in 1998

Wholesale Trade

- 1992 average jobs was 78,800; forecast for 1996 was 106,000; now revise down to 80,000
- 1992 average 78,800; forecast for 1998 is 80,000

Retail Trade

- Jobs declined by 17,700 (8%) from 1989-1992
- Original forecast for 1996 of 249,700 down-sized to 214,400 by 1998
- Retail trade is third largest industry in county
- Employment expected to advance by 13,200 (6.6%) between 1992 and 1998

Finance, Insurance, & Real Estate Services

- Expect continued growth through 1998, although at slower rate than previously estimated
- Services averaged 318,300 jobs in 1992; estimated to be 340,700 by 1998

Government

- 1992 showed increase of 6,900 jobs from 1989
- 112,100 jobs in 1992 expected to increase to 120,600 by 1998
- Budgetary constraints expected to slow growth; project 120,600 jobs in 1998
- Bulk of increase expected in area of state and local education

EDUCATION**Elementary & Secondary**

- Table of public school enrollment from 1989 to 1993
- Table of public school enrollment from 1988 to 1993

EMPLOYMENT

- Table comparing Orange County, California, U.S. labor force, employment and unemployment; table of top 50 private sector employers for 1993
- No employment/unemployment table contained in the prospectus

COMMERCIAL ACTIVITY

- Table summarizing the annual volume of taxable transactions within county from 1989 through first half of 1993
- Table summarizing the annual volume of taxable transactions within county from 1988 through 1992

AGRICULTURE

- Table of gross value of farm production for 1987 through 1992
- Agriculture only 0.7% of jobs in 1992
- U.S. Census of Agriculture in 1987 ranked county 68th of 3,141 in total market value of agricultural products sold
- Table of gross value of farm production for 1988 through 1993
- Agriculture only 0.7% of jobs in 1993
- Does not discuss U.S. Census; however, says CA D.F.A. ranked county 20th of 58 in total

COUNTY WATER SUPPLY & CALIFORNIA DROUGHT

- County experienced 6 years of drought from 1987 to 1992; water year 1993-1994 declared critically dry year; heavy rainfall in January 1993 resulted in a preliminary estimate of a \$40 million loss in the county due to flood damage
- The Metropolitan Water District has instituted phased rate surcharge program to reduce water delivery by 20-50%; several Orange County cities have introduced conservation measures; difficult to predict economic impact of drought on county
- [Information not in prospectus]
- [Information not in prospectus]

NATURAL DISASTERS; SEISMIC ACTIVITY/FIRES

- General information;
October 26, 1993, series
of fires in Southern
California, burning over
an estimated 300 homes
and 18,700 acres of land
in Orange County
- [Information not in
prospectus]

